

Ethics Training for Texas CPAs

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Course Learning Objectives

- Identify the characteristics of ethics.
- Recognize ethical reasoning used by accountants.
- Differentiate between rulings and principles of the AICPA' Code of Professional Conduct.
- Identify the six principles and list the eleven rules of the AICPA *Code of Professional Conduct*.
- Identify independence and objectivity issues using the *threats and safeguards approach*, a conceptual framework.
- Recognize ethics rulings on independence.
- Recognize the Texas State Board of Public Accountancy Rules of Professional Conduct.
- Identify licensing and disciplinary mechanisms for Texas CPAs.

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Chapter 1

Ethics and Ethical Reasoning

Learning Objectives

After studying this chapter, you will be able to:

- Identify the characteristics of ethics.
 - Recognize ethical reasoning used by accountants.
-

Ethics Defined

Merriam-Webster provides the following definitions of ethics:

- the discipline dealing with what is good and bad and with moral duty and obligation
- a set of moral principles
- the principles of conduct governing an individual or a group
- a guiding philosophy
- a set of moral issues or aspects (as rightness)

Ethics is the “science of morals”. A moral is an accepted rule or standard of human behavior. The understanding of “accepted” is “accepted by society”, and accepted only insofar as the behavior in question being behavior that affects others in the society, even if only indirectly. The implication of this definition is therefore that private actions that have no impact on others are a matter for personal morality, which is not of business or organizational concern.

However, the distinction between personal morality and business morality may not always be so clearly defined. This is because individuals bring personal values to their jobs and to the real or perceived problems of moral choice that confront them at work. Moral choices sometimes must be made because of tensions within individuals, between individuals, or between individuals and what they believe to be the values that drive their organizations.

Furthermore, business organizations do not operate in a social vacuum. Because of the ways business organizations can and do affect the lives and livelihoods of society at large, some would argue that business organizations are kind of “moral agents” in society. Therefore managers and general public alike often wrestle with defining exactly what constitutes the ethical way of doing business, and what constitutes proper constraints on individual self-interests, and by whom shall these constraints be imposed.

A further complexity results from the fact that businesses are increasingly becoming global in nature. Different countries have or seem to have vastly different customs and values. Understanding and assessing whether and how these different cultural and ethical conflicts should be taken into account is often most difficult.

Attitudes toward Ethics

Amoral:	Condone any actions that contribute to the corporate aim. Getting away with it is the key. No set of values other than greed.
Legalistic:	Obey the letter of the law but not the spirit of it, especially if it conflicts with profits. Ethics ignored until it becomes a problem
Responsive:	Take the view that there is something to gain from ethical behavior, Using ethics as a tool to attain corporate aim.
Emerging:	Ethical values becoming part of the culture. Codes of ethics being action documents, and likely to contain statements reflecting core value,
Ethical:	Total ethical profile. Everything done is ethical, and the right thing always done by everyone. The ideal.

In general, a key focus of ethics is the concept of integrity (or honesty). Integrity in broad terms will imply that no business-persons in the course of their business functions should be party to the falsification of any facts or information or make any statement which knowingly is misleading, false or deceptive in a material particular. Another major focus of ethics is professional competence and due care, which implies that business professionals should always perform their functions in accordance with law and regulations. In other words, business transactions and professional functions should not be undertaken unless one possesses the required competence and technical skills.

A more controversial focus is the area of freedom from conflicts of interests. The preferred position of many is that one should always avoid concurrent involvement in any business, occupation or activity, which might result in the compromising of integrity, objectivity and independence of decision making.

In defining law and ethics and their relationship to each other, it is necessary to distinguish between moral and legal rights and duties. Morally, a person's rights consist of claims that he can justly make to the conditions of well-being; his duties consist of what he can justly contribute to well-being. Legal rights and duties - that is, claims and obligations enforceable at law - may or may not be fully in harmony with prevalent moral opinion systems in which law and ethics and religion are closely interwoven. The impact of moral opinion on law varies with the type of political structure and influence of public opinion.

In free societies, the ultimate justification of law is that it serves moral ends. However, the dependence of law on moral principles must not be taken to imply that there is a set of moral principles, which can be laid down for guidance. However, most free societies are coming to be more or less consistent in principles that draw the line between law and morals. The task of ethics becomes two-fold: to bring out what is involved in the notion of a principle or norm of action and to recognize ideals that serve as agencies of guidance and control.

A number of consistent principles recognized in modern society are the individual, responsibility and equity. The end of law is to secure the greatest possible general individual self-assertion. In the Judeo-Christian ethic, responsibility is a given: the best ordering of human society in which the individual may come to full manhood and satisfying existence. On the basis of equitable doctrine, we can say confidently that morality is inseparable from the legal order; that right and wrong is part of the legal order.

Ethical Reasoning and Accountants

The largest part of the prior research projects which have been done on ethical issues in accounting have generally avoided theoretical discussions about "right and wrong" or "good and bad" choices. Instead, they have focused on determining whether or not accountants are abiding by the rules of professional conduct. There are basically two principles used to resolve ethical dilemmas, related to CPAs, which are utilitarianism and rule deontology.

<p>Utilitarianism (Teleological ethics)</p>	<p>The promotion that the best long-term interest of everyone concerned should be the moral standard: one should take those actions that lead to the greatest balance of good versus bad consequences</p>
<p>Deontology (Kantian ethics)</p>	<p>It deals with the concept of duty and the rightness of acts. It emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences.</p>

In utilitarianism, the focus is based on the consequences of an action rather than abiding by rules. Deontology, on the other hand, focuses on just the opposite. Under Deontology principles, an accountant would be more concerned with abiding by rules of professional conduct no matter what the consequences.

Case Study 1

For example, a 2008 study published in *The CPA Journal* attempted to determine how accountants, specifically auditors, used ethical reasoning when confronted with issues related to client confidentiality. Rule 301, Confidential Client Information, of the AICPA's Code of Professional Conduct states that a member in public practice cannot disclose confidential client information without the client's consent. However, this Rule does not affect a CPA's obligations:

1. To comply with a validly issued and enforceable subpoena or summons or with applicable laws and regulations
2. To discharge his/her professional obligations properly under Conduct Rules 202 and 203
3. To cooperate in a review of the CPA's professional practice under AICPA or state CPA society or board of accountancy authorization
4. To initiate a complaint with or respond to any inquiry made by the professional ethics division, trial board of the AICPA, or an investigative or disciplinary body of a state society or board of accountancy

In the study, a survey consisting of three different circumstances was sent to 100 randomly selected CPA's. Each CPA was asked to respond to each circumstance described using the following guide:

1. To inform or not inform a third party of confidential client information, and
 2. To indicate which response given in 1) was considered "good ethical behavior" if the Code was disregarded.
- Respondents were also asked to provide justification for their answers.

The following are the circumstances they were given:

“Scenario 1: James Corporation employs the regional CPA firm of Green and Cash to audit its financial statements. The firm has been asked to prepare quarterly financial statements. Bob Ethics, a staff accountant, was assigned to do the work. During the course of preparing the statements, Bob discovered that James Corporation materially understated net income on last year's tax return. Bob informed his supervisor about this and the client is asked to prepare an amended tax return. The client, however, refused to take corrective action.

Scenario 2: Johnson Manufacturing Corporation is a publicly owned company that manufactures equipment used by hospitals and medical laboratories. The company is audited by the national accounting firm of Adams & Pitre. One day, John, the senior in charge of the engagement overheard a conversation between two managers indicating that although they met inspection standards, they were aware of a defect in a particular piece of equipment, but they had not notified any of their customers because they felt the probability of malfunction was low. John takes this information to the controller and is told not to include it in the audit report. He then takes it to the manager on the engagement. The manager informs University Hospital, one of its clients, and also a major customer of Johnson Manufacturing Corporation, not to purchase any more equipment from Johnson. Johnson sues Adams & Pitre for violating the confidentiality rule.

Scenario 3: William Johnson, a CPA, served as a director of Last National Bank for a year. As a director, William may be held liable for damages if he fails to use care and prudence in administering bank affairs and such action causes the bank to suffer a financial loss. In the course of an audit, William discovered a seriously weakened financial position in a client who has a large loan at Last National Bank. Disclosure of this condition to the other bank directors would minimize the bank's loss, however, since the audit has not been completed, this would represent a violation of Rule 301 of the Code.¹”

According to the study, the following were the results, conclusions and implications:

“Scenario 1: Given a Code, most (78%) respondents would not inform the IRS. This is in agreement with the rule of conduct. Although the variability increased, most CPAs (70%) in this situation would make the same decision without a Code. This is consistent with the justification given that most CPAs perceived themselves to be an advocate of the client in a tax engagement. There was no perceived conflict in the rule of conduct and what most accountants perceived as good ethical behavior.

¹ “Ethical reasoning in confidentiality decisions,” by Barbara L. Adams, Fannie L. Malone, and Woodrow James, Jr., *The CPA Journal*, July 2008

Scenario 2: Most CPAs (78%) responding in this situation would adhere to the Code and not inform one client of information discovered while auditing another client. A large percentage (52%) of respondents, however, indicated that informing would be the "best ethical behavior." In most instances, "potential safety concerns" were cited as the justification for considering informing as the "best ethical behavior." Thus, there appears to be some conflict in adhering to the Code and the moral value of some CPAs.

Scenario 3: Given a Code, a majority (78%) of CPAs would not inform, which is in agreement with the Code. A lesser percentage (53%), however, feels this is the best ethical behavior.

Conclusions and Implications

The findings of this study indicate that CPAs usually adhere to the Code (rule deontology) in resolving issues involving confidentiality. However, such decisions are not always in accord with what they perceive as "good ethical behavior." The broad principles of the Code indicate that ethical conduct, in the truest sense, means more than abiding by a letter of a rule. It means accepting a responsibility to do what is honorable or doing that which promotes the greatest good to the greatest number of people, even if it results in some personal sacrifice.

Ethical Dilemmas in Accounting

The varying nature of ethical dilemmas in accounting make them very difficult to resolve. Deciding how to handle various forms of ethical dilemmas is an important attribute of the accounting profession. Individuals in the accounting profession have a considerable responsibility to the general public. Accountants provide information about companies that allow the public to make investment decisions for retirement, a child's education and major purchases such as a home. Because the general public is not in a position to judge the quality and integrity of work performed by accountants, in order for the public to be willing to rely on the information provided, there must be a level of confidence in the knowledge and behavior of accountants. Ethical behavior is necessary in the accounting profession to prevent fraudulent activities and to gain public trust. The main reason for ethical guidelines is not to provide an exact solution to every problem, but to aid in the decision-making process. An established set of guidelines provides an accounting professional with a compass to direct him toward ethical behavior. Specific responsibilities of the accounting profession are expressed in the various codes of ethics established by the major organizations such as the American Institute of CPAs. The AICPA Code of Professional Conduct outlines an accountant's responsibilities towards the public interest and emphasizes integrity, objectivity and due care.

The effects of ethical behavior in accounting are far reaching in the economy. Every business entity has an accounting professional provide information at some point in the organization's life cycle. One type of ethical dilemma presents itself when accounting professionals are tempted or enticed to alter financial results and often rationalize the behavior by calling it creative or aggressive accounting. Aggressive accounting is the process of employing questionable accounting methods to boost results. An accountant may record revenues and expenses in an incorrect manner or omit expenses altogether. Repeated incidences of aggressive accounting are a result of the lack of ethical behavior.

Case Study 2

Ethical Dilemma Example #1

One common illustration of an ethical dilemma involves management instructing a subordinate employee to record a transaction in an incorrect manner. For instance, a company with a Dec. 31 year-end calendar year, signs contracts with consumers to perform services. The contracts are usually signed Dec. 1 and are a year in length. Accounting principles require the company to record the revenue for the contract for one month only, the month of December. The remainder of the revenue is recognized on next year's financial statements. However, management instructs an employee to record the entire amount of the contract in December to boost revenues for the current year end. Management receives a bonus for the boosted revenue and the subordinate receives recognition in an upcoming performance review.

Solutions

To help CPA's take the proper steps towards resolving ethical dilemmas of this type, the AICPA has published an Ethics Decision Tree for CPA's in Business and Industry, and one for CPA's in Government. Both can be accessed at the following website:

<http://www.aicpa.org/INTERESTAREAS/BUSINESSINDUSTRYANDGOVERNMENT/RESOURCES/PROFESSIONALDEVELOPMENT/ETHICSDECISIONTREE/Pages/default.aspx>

The AICPA also has an ethics hotline (888-777-7077) for practitioners to contact if they confront difficulties in resolving their ethical dilemmas.

In summary, in situations such as these, the decision tree prompts practitioners to take the issue to their manager and then, if the result is unsatisfactory, to a trusted senior executive within the firm. Ultimately, if no satisfactory outcome is achieved, the issue should be elevated first to the company's ethics committee (if one exists) and then to the Audit Committee of the Board of Directors. If these attempts to resolve the issue are unsuccessful, the practitioner will have to consider whether it is appropriate to continue employment with the company and, depending upon the severity of the issue, be compelled to report it the external auditors, and ultimately to a regulatory agency, bank or other lending institution, or to the owners or an investor committee.

There are other types of ethical dilemmas that are somewhat more intricate to resolve because they do not entail the obviously aggressive accounting methods such as those depicted in the first example where blatant attempts are made to record revenues and expenses in an incorrect manner. In a number of instances, dilemmas may present a variety of viable solutions. These types of dilemmas have the following characteristics:

- There are multiple stakeholders involved
- The stakeholders generally have equally legitimate interests
- The interests of the stakeholders are competing/conflicting
- There is often more than one right choice
- Only one choice can be made

Ethical Dilemma Example #2

A financing company approaches its year end and finds that earnings are not likely to be sufficient to maintain compliance with the loan covenants of its major lender and source of capital. Given the recent acquisition of a very large pool of performing loans from another finance company, the CFO asserts that the provision for loss reserve ratio be reduced from its historical average of 4% to 3.7%. By doing so, earnings would increase to a level that would satisfy the loan covenant. The accounting department is divided on the issue, and are concerned as to the justification for the departure from the standard 4% loss reserve ratio.

As a practical matter, in these types of situations where there is much more grey area, CPA's should utilize the following authoritative guidance when attempting to resolve ethical dilemmas of this type:

- Ensure all decision stakeholders have been identified
- Identify all critical facts and alternative actions
- Determine the benefit and detriment of each alternative on each stakeholder
- Weigh all applicable rules, regulations and laws against each alternative
- Select the alternative that complies with the rules and which maximizes benefit and minimizes harm

By following the above approach, a collective agreement on the proper outcome may be achieved. For example, fact gathering might determine that the large pool of loans acquired had a historically lower loss rate than the company's existing book of business. Additionally, the decision could be made to add a disclosure to the year-end financials attributing the reduction in the loss ratio to expected improvement in management of the acquired portfolio by the company. That way, the users of the financial statements could draw their own conclusions as to whether further investment in the company's lending operations was warranted.

Ethical Dilemma Example #3

Q: Rose is an accounting manager who has discovered that her company is violating environmental regulations. If her immediate superior is involved, what is her appropriate action?

A: The accountant/finance professional should discuss such problems with the immediate superior except when it appears that the superior is involved, in which case the problem should be presented initially to the next higher managerial level. If satisfactory resolution cannot be achieved when the problem is initially presented, submit the issues to the next higher managerial level. If the immediate superior is the chief executive officer, or equivalent, the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners.

Chapter 1 Review Questions

1. All of the following are a major focus of ethics EXCEPT:
 - A. Integrity
 - B. The compromising of integrity, objectivity and independence of decision making.
 - C. Professional competence and due care
 - D. Freedom from conflicts of interest

Chapter 2

AICPA Code of Professional Conduct

Learning Objectives

After studying this chapter, you will be able to:

- Differentiate between rulings and principles of the AICPA' Code of Professional Conduct.
 - Identify the six principles and list the eleven rules of the AICPA *Code of Professional Conduct*.
 - Identify independence and objectivity issues using the *threats and safeguards approach*, a conceptual framework.
 - Recognize ethics rulings on independence.
-

This chapter covers the AICPA's *Code of Professional Conduct*. It presents a condensed but comprehensive summary of the AICPA Code of Conduct, along with summaries of AICPA Ethics Interpretations for the 11 Rules of Conduct. It also explains the *threats and safeguards approach* to resolve ethical dilemmas faced by accountants. The final section illustrates some cases of ethics violations.

AICPA's Code of Professional Conduct

AICPA's *Code of Professional Conduct* code includes the following:

- *Principles*. The 6 principles establish ideal standards of ethical conduct stated in philosophical terms. They express the profession's recognition of its responsibilities to the public, to clients, and to colleagues. They guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The Principles call for an unwavering commitment to honorable behavior, even at the sacrifice of personal advantage. There are *six* principles that are goal-oriented but *nonbinding*.
- *Rules of conduct*. These rules are the minimum standards of ethical conduct stated as specific rules. There are *eleven* rules of conduct that are *enforceable (binding)*.
- *Interpretations*. Interpretations of rules are intended to clarify the rules of conduct. They are not officially enforceable, but a practitioner must justify any departure.

Exhibit 1
The Six Principles

<i>The Six Principles</i>		
1	0.300.020	Responsibilities
2	0.300.030	The Public Interest
3	0.300.040	Integrity
4	0.300.050	Objectivity and Independence
5	0.300.060	Due Care
6	0.300.070	Scope and Nature of Services

The first five of these principles are equally applicable to all members of the AICPA, regardless of whether they practice in a CPA firm, work as accountants in business or government, are involved in some other aspect of business, or are in education. One exception is the last sentence of objectivity and independence. It applies only to members in public practice, and then only when they are providing attestation services such as audits. The sixth principle, scope and nature of services, applies only to members in public practice. That principle addresses whether a practitioner should provide a certain service, such as providing personnel consulting when an audit client is hiring a chief information officer (CIO) for the client's IT function. Providing such a service can create a loss of independence if the CPA firm recommends a CIO who is hired and performs incompetently.

Exhibit 2
The Eleven Rules of Conduct

<i>The Eleven Rules of Conduct</i>		
1	1.100, 2.100	Integrity and Objectivity
2	1.200	Independence
3	1.300, 2.300	General Standards
4	1.310, 2.310	Compliance with Standards
5	1.320, 2.320	Accounting Principles
6	1.400, 2.400	Acts Discreditable
7	1.510	Contingent Fees
8	1.520	Commissions and Referral Fees
9	1.600	Advertising and Other Forms of Solicitation
10	1.700	Confidential Client Information
11	1.800	Form of Organization and Name

Note: Rules with a prefix of 1 are applicable to members in public practice and rules with a prefix of 2 are applicable to members in business.

Summaries of the Six Principles

Responsibilities. In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities. Members also have a continuing responsibility to cooperate with each other to improve the art of accounting, maintain the public's confidence, and carry out the profession's special responsibilities for self-governance.

The Public Interest. Members should act to benefit the public interest, honor the public trust, and demonstrate commitment to professionalism. The AICPA adopted the ethical standards because a distinguishing mark of a profession is an acceptance of responsibility to the public.

Integrity. Members should perform all professional responsibilities with the highest sense of integrity to maintain public confidence. Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage.

Objectivity and Independence. A member should maintain objectivity and be free of conflicts of interest. A member in public practice should be independent in fact and appearance when providing attestation services. Objectivity is a state of mind, a quality that lends itself to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. *Independence of mind* is the state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism. *Independence in fact* is the member's ability to take an unbiased viewpoint in the performance of professional services. *Independence in appearance* is the avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.

Due Care. A member should follow the profession's technical and ethical standards, strive for improved competence and quality services, and discharge professional responsibility to the best of the member's ability. Members must adequately plan and supervise any activity for which they are responsible.

Scope and Nature of Services. A member in public practice should follow the Principles of the *Code of Professional Conduct* in determining the nature and scope of services.

Conceptual Framework – Threats and Safeguards Approach

The threats and safeguards approach can help members comply with the rules in situations not explicitly addressed in the code. It is an approach that the AICPA's Professional Ethics Executive Committee also uses when developing the code's interpretations and rulings.

The threats and safeguards approach identifies threats to compliance with the rules governing both objectivity and independence and evaluates the significance of those threats. If a threat is not at an acceptable level, members should determine whether safeguards can eliminate or reduce the threat to an acceptable level and, if so, apply such safeguards or, if not, avoid the situation that creates the threat. Members should evaluate in-the-aggregate a situation with multiple threats since the cumulative effect could be at an unacceptable level.

Identifying threats. Members often face risks of encountering relationships or circumstances that could compromise compliance with the roles (in other words, threats) in their duties or work environments.

Six threat categories are identified to help members for members practicing in the business or government sector are identified and develop sensitivity to potential threats:

1. *Self-review threat.* The threat that a member will not appropriately evaluate the results of prior services performed by the member himself or herself, or by an individual in the member's firm or employing organization.
2. *Advocacy threat.* The threat that a member will promote a client or employer's position to the point that his or her objectivity is compromised.
3. *Adverse interest threat.* The threat that a member will not be objective because his or her interests are in opposition to those of a client or employer.
4. *Familiarity threat.* The threat that because of a long or close relationship with a client or employer, a member will become too sympathetic to their interests or too accepting of their work.
5. *Undue influence threat.* The threat that a member will subordinate his or her judgment to that of an individual associated with a client, employer or other relevant third party because of the individual's (1) reputation or expertise, (2) aggressive or dominant personality, or (3) attempts to coerce or exercise excessive influence over the member.
6. *Self-interest threat.* The threat that a member will act in a manner that is adverse to the interests of his or her firm, employer, client or the public, as a result of the member or his or her close family member's financial interest in or other relationship with a client or the employer.

A seventh threat, the threat of management participation, applies only to members in public practice.

Examples of Threats to Compliance with AICPA Rules of Conduct

Adverse Interest Threat
<ol style="list-style-type: none"> a. The client has expressed an intention to commence litigation against the member. b. A client or officer, director, or significant shareholder of the client participates in litigation against the firm. c. A subrogee asserts a claim against the firm for recovery of insurance payments made to the client. d. A class action lawsuit is filed against the client and its officers and directors and the firm and its professional accountants.
Advocacy Threat
<ol style="list-style-type: none"> a. A member provides forensic accounting services to a client in litigation or a dispute with third parties. b. A firm acts as an investment adviser for an officer, a director, or a 10 percent shareholder of a client. c. A firm underwrites or promotes a client's shares. d. A firm acts as a registered agent for a client. e. A member endorses a client's services or products.
Familiarity Threat
<ol style="list-style-type: none"> a. A member's immediate family or close relative is employed by the client. b. A member's close friend is employed by the client. c. A former partner or professional employee joins the client in a key position and has knowledge of the firm's policies and practices for the professional services engagement.

<ul style="list-style-type: none"> d. Senior personnel have a long association with a client. e. A member has a significant close business relationship with an officer, a director, or a 10 percent shareholder of a client.
Self-Interest Threat
<ul style="list-style-type: none"> a. The member has a financial interest in a client, and the outcome of a professional services engagement may affect the fair value of that financial interest. b. The member's spouse enters into employment negotiations with the client. c. A firm enters into a contingent fee arrangement for a tax refund claim that is not a predetermined fee. d. Excessive reliance exists on revenue from a single client.
Self-Review Threat
<ul style="list-style-type: none"> a. The member relies on the work product of the member's firm. b. The member performs bookkeeping services for a client. c. A partner in the member's office was associated with the client as an employee, an officer, a director, or a contractor.
Undue Influence Threat
<ul style="list-style-type: none"> a. The firm is threatened with dismissal from a client engagement. b. The client indicates that it will not award additional engagements to the firm if the firm continues to disagree with the client on an accounting or tax matter. c. An individual associated with a client or any relevant third party threatens to withdraw or terminate a professional service unless the member reaches certain judgments or conclusions.

Evaluating the significance of a threat. The existence of a threat does not necessarily mean noncompliance with the rules; rather, members should evaluate a threat's significance by considering whether a reasonable and informed third party, weighing all quantitative and qualitative facts and circumstances, would likely conclude that the threat would compromise the member's compliance with the rules. If this evaluation finds that the threat would not compromise a member's compliance, the threat is at an acceptable level, requiring no further evaluation under the guide. If the evaluation finds the threat at an unacceptable level, the member should identify and apply appropriate safeguards.

Identifying and applying safeguards. Safeguards are controls that mitigate or eliminate threats to independence. Required or prohibited actions and internal control measures can serve as safeguards to eliminate or reduce threats to acceptable levels. The profession, legislation and public regulations create some safeguards for all members. Employers implement other safeguards in the specific work environment. Members in public practice also may consider their client's safeguards when evaluating the significance of a threat.

Examples of safeguards and associated threats they might reduce are:

1. Peer reviews (actions required by the profession) that consider appropriate reliance on external evidence in attest engagements reduce undue influence threats.
2. Periodic rotations of senior members on an attest engagement (actions required by Sarbanes-Oxley legislation or a firm's internal controls) reduce familiarity threats.
3. Limitations of services to clients whose billings would be significant to the firm (actions prohibited by a firm's internal controls) reduce undue influence and self-interest threats.
4. Avoiding joint ventures with a client (actions prohibited in a firm's internal controls) reduces advocacy and self-interest threats.
5. Corporate governances that restrict certain services by the corporation's external auditors (actions prohibited by the client's internal controls) reduce self-review threats.
6. Corporate policies that stress ethical behavior and provide channels to discuss ethical issues without fear of retribution (workplace internal controls, "tone at the top") reduce undue influence threats.

Determining which safeguard to apply requires judgment, since a safeguard's effectiveness can vary from one environment to another. Members should analyze a particular situation's facts and circumstances, identify significant threats and then design safeguards, considering:

- The safeguard's objective.
- Parties who will be subject to the safeguard.
- How the safeguard will be applied (for example, uniformly, consistently, objectively).
- Who will apply the safeguard (for example, a third party, a supervisor, a computer).

A threat is reduced to an acceptable level if, after applying safeguards, a reasonable and informed third party would likely conclude that compliance with the rules is not compromised.

What if there are no effective safeguards? A threat may be so significant that no safeguard can eliminate or reduce it to an acceptable level. If so, providing the specific professional or employee service will likely cause noncompliance with the rules. While declining or discontinuing the service would prevent a rules violation, the member should also consider the stronger response of resigning from the client or employment position.

Case Study 1

Applying Threats and Safeguards Approach to Ethics Violation Cases

Case 1: Company controller Davidson, CPA, prepared his employers 2007 financial statements knowing that they misstated revenues. The company's CEO, who could fire Davidson at will, "strongly urged" Davidson to record sales at full invoice prices despite customers' fights to return merchandise long after a normal return period. Davidson's brother-in-law, a company in-house lawyer, wrote the sales contracts and assured Davidson that recording the full sales amounts was appropriate. After investigating the misstatement, the Illinois Department of Financial and Professional Regulation revoked Davidson's CPA certificate for "negligence in the preparation of financial statements" and "subordination of judgment" even though he was not in public practice.

Solution: CPA Davidson, whose boss urged him to record transactions contrary to GAAP and whose brother-in-law analyzed GAAP for him, should have referred to subordination interpretation that prescribes potentially confrontational actions when a member's interpretation of GAAP differs from those of his or her supervisors.

However, with the "threats and safeguards" approach, the unwelcomed need to invoke the subordination Interpretation might have been avoided, as in this scenario: Davidson recognized the CEO's authority to fire him at-will as an *undue influence threat* and his brother-in-law's legal counsel as a *familiarity threat*. Davidson wrote a memo to his files discussing both threats and his belief that a reasonable and informed third party, weighing all the facts and circumstances, would likely conclude that the threats--separately and in the aggregate--compromise his compliance with rules Integrity and Objectivity, General Standards and Accounting Principles.

He considered actions or policies that might reduce the two threats to acceptable levels and wrote to the company's audit committee suggesting safeguards to protect his objectivity: (1) an officer's employment termination should require a due process hearing before an independent arbitrator, allowing the officer to respond to allegations; and (2) staff preparing financial statements cannot be related to staff generating transactions or related documents. The audit committee adopted the due process personnel policy and assigned Davidson's brother-in-law to other legal matters. Davidson properly deferred revenue recognition on the dubious sales in accordance with the provisions of ASC 605-15-25-1, *Revenue Recognition: Products* (FAS-48, *Revenue Recognition When Right of Return Exists*).

Case 2: The California Board of Accountancy disciplined Norman & Co., CPAs, (the firm's name and other facts have been fictionalized) when it audited a bank's financial statements while the firm's consulting group concurrently sold the client's debt consolidation services. The Board of Accountancy imposed a three-year CPA license probation plus frequent and costly peer reviews.

Details: Two audit team members familiar with the AICPA's threats and safeguards approach knew that the firm's consulting group was negotiating a client-firm joint marketing venture and wrote memos identifying a *self-review threat*, *advocacy threat*, *self-interest threat* and independence issues. Their memo labeled the threats severe and urgent. The lead partner found that no safeguards could adequately reduce the threats to acceptable levels, and the firm immediately withdrew from the nonaudit activities.

Ethical Conflicts Unrelated to Threats

Members may confront ethical conflicts due to internal or external work-environment pressures or conflicts within professional standards unrelated to threats described above. For example, a member may encounter a fraud and feel ethically bound to report it; but reporting the fraud could breach Rule 301's mandate to maintain client confidentiality. To resolve such ethical conflicts and comply with the rules, the guide recommends that members:

1. Recognize and consider all relevant facts and circumstances, including applicable rules, laws or regulations,
2. Consider the ethical issues involved,
3. Consider established internal procedures, and then
4. Formulate alternative courses of action.

After weighing the consequences of each course of action, the member should select the course that best enables compliance with the rules. Before pursuing the selected course of action, the member may want to consult with legal counsel, applicable professional bodies and appropriate firm or employer personnel.

If the conflict remains unresolved after pursuing the selected course of action, the member should consider further consultation with those advisers to review the process and reach a different resolution. Members may be well-advised to document the ethical conflict's substance, details of discussions and suggested decisions.

What if there is no effective resolution? If, after exhausting all reasonable possibilities, the ethical conflict remains unresolved, members will probably not be in compliance with the rules if they remain associated with the matter creating the conflict. In this case, members should consider withdrawing from the engagement team or specific assignment, and perhaps consider the stronger response of resigning from the client or employment position.

Summaries of the Eleven Rules

1.100 - Integrity and Objectivity Rule

All members must maintain objectivity and integrity, be free of conflicts of interest, not knowingly misrepresent facts, and not subordinate his/her judgment to others when performing professional services.

Interpretations

1.110 Conflicts of Interest

A member or his or her firm may be faced with a conflict of interest when performing a professional service. In determining whether a professional service, relationship or matter would result in a conflict of interest, a member should use professional judgment, taking into account whether a reasonable and informed third party who is aware of the relevant information would conclude that a conflict of interest exists.

A conflict of interest creates adverse interest and self-interest threats to the member's compliance with the "Integrity and Objectivity Rule" [1.100.001]. For example, threats may be created when

- a. the member or the member's firm provides a professional service related to a particular matter involving two or more clients whose interests with respect to that matter are in conflict, or
- b. the interests of the member or the member's firm with respect to a particular matter and the interests of the client for whom the member or the member's firm provides a professional service related to that matter are in conflict.

Certain professional engagements, such as audits, reviews and other attest services require independence. Independence impairments under the "Independence Rule" [1.200.001], its interpretations, and rulings cannot be eliminated by the safeguards provided in this interpretation or by disclosure and consent.

When a conflict of interest exists, the Integrity and Objectivity rule will not prohibit the service if disclosure is made to and permission is obtained from the appropriate parties. The member should disclose the nature of the conflict of interest to clients and other appropriate parties affected by the conflict and obtain their permission to perform the professional services. The member should disclose the conflict of interest and obtain consent even if the member concludes that threats are at an acceptable level.

In cases where an identified threat may be so significant that no safeguards will eliminate the threat or reduce it to an acceptable level, or the member is unable to implement effective safeguards, the member should

- a. decline to perform or discontinue the professional services that would result in the conflict of interest; or
- b. terminate the relevant relationships or dispose of the relevant interests to eliminate the threat or reduce it to an acceptable level.

The following are examples of situations in which conflicts of interest may arise:

- a. Providing corporate finance services to a client seeking to acquire an audit client of the firm, when the firm has obtained confidential information during the course of the audit that may be relevant to the transaction
- b. Advising two clients at the same time who are competing to acquire the same company when the advice might be relevant to the parties' competitive positions
- c. Providing services to both a vendor and a purchaser who are clients of the firm in relation to the same transaction
- d. Preparing valuations of assets for two clients who are in an adversarial position with respect to the same assets
- e. Representing two clients at the same time regarding the same matter who are in a legal dispute with each other, such as during divorce proceedings or the dissolution of a partnership
- f. Providing a report for a licensor on royalties due under a license agreement while at the same time advising the licensee of the correctness of the amounts payable under the same license agreement
- g. Advising a client to invest in a business in which, for example, the immediate family member of the member has a financial interest in the business
- h. Providing strategic advice to a client on its competitive position while having a joint venture or similar interest with a competitor of the client
- i. Advising a client on the acquisition of a business which the firm is also interested in acquiring
- j. Advising a client on the purchase of a product or service while having a royalty or commission agreement with one of the potential vendors of that product or service
- k. Providing forensic investigation services to a client for the purpose of evaluating or supporting contemplated litigation against another client of the firm
- l. Providing tax or personal financial planning services for several members of a family whom the member knows to have opposing interests
- m. Referring a personal financial planning or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement

1.120 Gifts and Entertainment

When a member offers to a client or accepts gifts or entertainment from a client, self-interest, familiarity, or undue influence threats to the member's compliance with the "Integrity and Objectivity Rule" may exist.

1.130 Preparing and Reporting Information

Knowing Misrepresentations in the Preparation of Financial Statements or Records

Threats to compliance with the “Integrity and Objectivity Rule” would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards and the member would be considered to have knowingly misrepresented facts in violation of the “Integrity and Objectivity Rule,” if the member:

- a. makes, or permits or directs another to make, materially false and misleading entries in an entity’s financial statements or records;
- b. fails to correct an entity’s financial statements or records that are materially false and misleading when the member has the authority to record the entries; or
- c. signs, or permits or directs another to sign, a document containing materially false and misleading information.

Subordination of Judgment

The “Integrity and Objectivity Rule” prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services for a client, for an employer, or on a volunteer basis. The interpretation addresses differences of opinion between a member and his or her supervisor or any other person within the member’s organization.

1. If the member concludes that a material misstatement would result, (s)he should consult the appropriate higher level(s) of management and should consider documenting relevant matters.
2. If, after such discussions, the member concludes that action was not taken, (s)he should consider the continuing relationship with the employer, the obligation to communicate with third parties, and the desirability of consulting legal counsel.

1.200 - Independence Rule

A member in public practice should be independent when performing professional services as required by standards-setting bodies.

1.260.020 Loans and Leases with Lending Institution

1. *Grandfathered loans.* Independence is not impaired by (a) unsecured loans that are not material to the covered member’s net worth or (b) secured loans (including home mortgages) provided that the loans were obtained from a financial institution under its normal lending procedures, terms, and requirements
2. *Other permitted loans.* The following loans are permitted even if the client is one for which independence is required, provided that they are obtained under normal lending procedures, terms, and requirements and are always kept current:
 - a. Automobile loans and leases collateralized by the automobile
 - b. Loans fully collateralized by the cash surrender value of insurance
 - c. Loans fully collateralized by cash deposits
 - d. Credit cards and overdraft reserve accounts with an aggregate outstanding balance of \$10,000 or less on a current basis by the payment due date

Note: Loans from financial institution clients may impact the CPAs objectivity and independence since any kind of favorable treatment by the financial institution would create a financial interest in the institution. Any direct financial interest by the CPA causes him to lose independence.

Case Study 2

Situation: John Woods, a partner of Woods & Costas, CPAs, has an indirect financial interest in the auditor's client, Alpha Manufacturing that is immaterial to John's net worth.

Independent: An immaterial, indirect financial interest does not impair an auditor's independence.

Situation: Kelly Costas, a partner of Woods & Costas, owns a vacation home with Steve Hunter, a principal shareholder of Alpha Manufacturing. The value of the vacation home is material to Kelley Costas.

Not Independent. An auditor's joint interest in a vacation home with a principal shareholder of a client (presumably one able to exercise significant influence over the client) is considered a joint closely held investment that impairs independence if it is material to the auditor.

1.265.010 Cooperative Arrangements with Attest Clients

1. Independence is impaired if, during the engagement or at the time of expressing an opinion, a member's firm had any material cooperative arrangement with the client.
 - a. A cooperative arrangement means joint participation in a business activity.
 - b. A cooperative arrangement is not present when (1) the participants are governed by separate understandings, (2) responsibility for the other party's activities does not exist, and (3) neither party is the other's agent.

1.275.010 Honorary Director or Trustee of Not-For-Profit Organizations

A partner or professional employee of a firm holding an honorary position with a not-for-profit organization will sometimes allow his/her name to be used on letterheads and circulated materials to lend prestige to the group. Independence is not impaired if the position is clearly honorary and the individual is not able to vote or participate in board or management decisions. Moreover, (s)he must be identified as an honorary director or trustee.

1.277 Employment or Association with Attest Client

1. A former partner or professional employee of the firm who is employed by or associated with an attest client in a key position impairs the firm's independence unless:
 - a. Amounts due to the former partner or professional employee are not material to the firm, and the payment formula is fixed during the payout period. Retirement benefits may also be adjusted for inflation, and interest may be paid.
 - b. The former partner or professional employee cannot influence the firm's operations or financial policies.
 - c. Once employed or associated with the client, the former partner or professional employee does not participate or appear to participate in, and is not associated with, the firm, regardless of compensation, for example, by consulting, use of an office, or inclusion in membership lists.

- d. The engagement team considers the risk that the partner or professional employee's knowledge of the audit plan will reduce audit effectiveness.
- e. The firm assesses when team members can effectively deal with the partner or professional employee.
- f. The engagement is reviewed to determine whether team members maintained professional skepticism in dealings with the partner or professional employee.

1.279 Consideration or Subsequent Employment or Association with Attest Client

1. A team member's consideration of employment or association with the client impairs independence absent prompt reporting to the firm and removal from the team.

1.290 Effect of Actual or Threatened Litigation

1. Independence is impaired when litigation is begun by
 - a. The present management alleging deficiencies in audit work
 - b. The member alleging management fraud or deceit
2. An expressed intention by the management to litigate against the member for alleged deficiencies in audit work will impair independence if it is probable that the claim will be filed.
3. Independence is not impaired when the threatened or actual litigation is not related to the audit and the amount is not material. Examples include disputes over billings for services and results of tax advice.
4. If a reasonable person would conclude that litigation poses an unacceptable risk of impairment of independence, the member should disengage or disclaim an opinion for lack of independence.

Case Study 3

Situation: The management of Alpha Manufacturing is being sued by shareholders due to some previous irregularities in financial statements audited by Woods & Costas, CPAs. Alpha is likely to file a cross claim against Woods & Costas.

Not Independent. Independence is not necessarily impaired when a client is sued regarding previous financial statements. However, threatened litigation by current client management asserting deficient audit work impairs independence.

1.295 Nonattest Services

1. Before a member and his or her firm performs nonattest services (such as tax or consulting services) for an attest client, (s)he must avoid impairment of independence. If the applicable independence rules of an authoritative body (e.g., the SEC or a state board of accountancy) are more restrictive, the member must comply with them.
2. General Requirements. Performing management functions or making management decisions impairs independence, but providing advice, research, and recommendations does not.
 - a. The member should be satisfied that the client will make an informed judgment about the results of nonattest services and be able to designate a competent employee (preferably a senior manager) to oversee the services; evaluate their adequacy and results;

- make management decisions and perform management functions; accept responsibility for results; and establish and maintain internal controls.
- b. The member and client should agree about the objectives and limitations of the engagement, the services to be performed, and mutual responsibilities. The understanding should be documented in writing. This requirement does not apply to routine services, and those provided before the client became an attest client.
3. General activities that impair independence include
 - a. Exercise or possession of authority over transactions on a client's behalf
 - b. Preparing source documents evidencing transactions
 - c. Custody of client assets
 - d. Supervision of client employees in normal activities
 - e. Determining member recommendations to be implemented
 - f. Reporting to the board on behalf of management
 - g. Service as a stock transfer or escrow agent, registrar, or general counsel
 - h. Establishing or maintaining controls for a client, such as performing ongoing monitoring.
 4. Examples of nonattest services that may not impair independence if the general requirements are met include bookkeeping, disbursement, benefit plan administration (e.g., preparing participant account valuations and statements), investment advisory, finance, executive search, business risk consulting, and IT (but designing a system or operating a network impairs independence).
 5. *Tax compliance services.* Preparing a return and transmitting it and the payment does not impair independence if (a) the member does not have control of client funds and (b) the client-designated person who oversees the process approves the return and, if required, signs it. But a member's signing and filing the return impairs independence unless (a) the taxing authority has a procedure in place for such action or (b) a designated client manager has reviewed the documents and authorized the member to sign and file. Authorized representation of a client in administrative proceedings does not impair independence if the client gives prior agreement to the resolution of the tax matter. But representation in a court or public hearing is an impairment.
 6. *An appraisal, valuation, or actuarial service* impairs independence if the results are material to the financial statements and significant subjectivity is involved. For example, a valuation for a business combination, but not an actuarial valuation for a pension liability, usually involves significant subjectivity.
 7. *Forensic accounting services.* Litigation services involve assisting in actual or potential legal or regulatory proceedings. They include expert witness services, that is, the expression of an opinion based on the member's expertise, not his/her knowledge of disputed facts. These services impair independence unless (a) they are rendered to a large group of parties, (b) no attest client is the lead plaintiff or defendant, and (c) other requirements related to the influence of attest clients on the proceedings are met. However, testimony as a fact witness does not impair independence.
 8. *Internal audit assistance services* impair independence unless the member ensures that the client understands its responsibility for internal control and managing the internal audit function. Accordingly, the member must ensure that the client (a) designates an individual(s) with suitable skill, knowledge, or experience (preferably a senior manager) to oversee internal audit; (b) determines the scope, risk, and frequency of its activities; (c) evaluates its findings; and (d) evaluates the adequacy of its procedures.
 9. SEC regulations issued under the Sarbanes-Oxley Act of 2002 prohibit auditors of issuers (public companies) from performing certain nonaudit services:

- a. Appraisal and other valuation services if the results are subject to audit.
- b. Designing and implementing financial information systems if the results are subject to audit.
- c. Actuarial functions if the results are subject to audit.
- d. Management services.
- e. Human resource services.
- f. Bookkeeping if the results are subject to audit.
- g. Legal and other expert services not pertaining to the audit (client advocacy, including internal fact-finding and providing explanations of conclusions).
- h. Investment banking or advisory services.
- i. Broker-dealer services.
- j. Internal audit outsourcing that involves financial accounting controls, systems, or statements.
- k. Tax services not preapproved by the audit committee or that are prohibited nonaudit services.
- l. Any other nonaudit services not preapproved by the audit committee.

Case Study 4

Situation: Alpha Manufacturing solicited Woods & Costas, CPAs to perform permitted tax services. Alpha's audit committee approved the arrangement. These services consist of preparing an income tax return. The return is approved and signed by a designated client manager.

Independent: Independence is not impaired if the firm provides tax services as long as the services are not prohibited nonaudit services and the provision of the services has been approved by the client's audit committee. But preparing a tax return could impair independence, e.g., if the member had control of client funds or the return was not approved by a client-designated person.

1.297 Independence Standards and Attest Engagements

1. This interpretation applies only to engagements, other than examinations and reviews, covered by SSAEs when the use of the report is restricted.
2. The following covered members and their immediate families must be independent in relation to the responsible party:
 - a. An individual on the attest engagement team.
 - b. An individual who directly supervises or manages the attest engagement partner.
 - c. Individuals who consult with the attest engagement team about technical or industry-related matters specific to the engagement.
3. Independence is impaired and cannot be reduced to an acceptable level by any safeguards if the firm had a material relationship with the responsible party prohibited under rules covering financial interests, trustees or executors, joint closely held investments, or loans.
4. A firm may provide nonattest services to the responsible party that are prohibited due to an association as an employer, director, officer, promoter, voting trustee, or pension trustee. However, if they do not relate directly to the subject matter of the attest engagement, independence is not impaired. (1.297.020.03)
5. When the party that engages the firm is not the responsible party or associated therewith, individuals on the attest engagement need not be independent of the party that engaged the firm. However, they should consider their responsibilities regarding conflicts of interest.

Other Ethics Rulings on Independence

Independence Not Impaired

1. The member provides advisory services for a client.
2. A member is designated to serve as an executor of an individual's estate that owns the majority of the stock of a corporation. Independence with respect to the corporation is not impaired unless the member serves as executor.
3. Independence is not impaired if a member audits an employee benefit plan unless a partner or professional employee of the firm had significant influence over the employer(s); was in a key position with the employer; or was associated with the employer as a promoter, underwriter, or voting trustee.
4. The mere servicing of a member's loan by a client financial institution.
5. When a covered member has a checking or savings account, certificate of deposit, or money market account in a client financial institution, provided the amounts are fully insured. Uninsured amounts do not impair independence if they are immaterial or if they are reduced to an immaterial balance within 30 days. A firm's independence is not impaired if the probability is remote that the depository institution will have financial difficulty.
6. If a member leases property to or from a client under an operating lease with terms comparable to those of similar leases, and all amounts are paid in accordance with the lease. If, however, the lease is a capital lease, independence would be impaired unless the lease is tantamount to a permitted loan.
7. Inclusion of a clause in an engagement letter providing for member indemnification by the client.
8. Performing extended audit services regarding reporting on internal control if management assumes responsibility for control, and management does not rely on the member's work as the primary basis for its assertion.

Case Study 5

Situation: Ben Costas, a partner of Woods & Costas, owns the building in which Alpha Manufacturing's corporate offices are located. The lease qualifies as a capital lease but not a grandfathered loan.

Not independent: Leasing property to a client under a capital lease is deemed to be a loan to the client. Independence is impaired unless the loan is a grandfathered loan.

Situation: The engagement letter sent to Alpha Manufacturing by Woods & Costas contains an indemnification clause. It requires Alpha to reimburse Green & Martin for any losses due to a lawsuit based on Alpha's financial statements.

Independent: Inclusion of a clause in the engagement letter providing for indemnification of the firm by the client does not impair independence.

Independence Impaired

1. The member signs or cosigns checks or purchase orders or exercises general supervision to ensure compliance as a representative of a creditors' committee in control of a debtor corporation.

2. With respect to a foundation and an estate if the member is a trustee of the foundation that is the beneficiary of the estate.
3. A CPA is a director of a company and an auditor of the profit sharing and retirement trust.
4. If billed or unbilled fees, or a note arising from the fees, for client services rendered more than 1 year before the current year's report date remain unpaid. (1.230.010.02)
5. Audit fees that are long past due take on the characteristics of a loan under Independence Rule. Not applicable if the client is in bankruptcy. (1.230.010.03)
6. When a CPA is on the board of directors of a fund-raising organization; unless the position is honorary.
7. The use of partners, shareholders, and professional employees from another firm that is not independent of the client. Their work can be used in the same manner as that of internal auditors.
8. A CPA's service on a client's advisory board unless it
 - a. Is in fact advisory.
 - b. Has no authority to make management decisions, and
 - c. Is distinct from the board of directors with few common members.
9. A CPA who is not independent may not express an audit opinion or issue a review report, but (s)he may issue a compilation report after disclosing the lack of independence.
10. A member who is a general partner in a partnership that invests in a client. If the member is a limited partner, independence would not be impaired unless the interest in the client is material.
11. Agreeing to indemnify a client for losses arising from lawsuits, etc., that relate directly or indirectly to client acts impairs independence.
12. When a member has significant influence over an entity with significant influence over a client.
13. If a member performs investment management or custodial services for an employee benefit plan sponsored by a client, with respect to the plan. Independence is also impaired regarding the client-sponsor of a defined benefit plan if the assets involved are material to the plan or sponsor. Independence is not impaired regarding a client-sponsor a defined contribution plan if the member performs no management functions and does not have custody of the assets.
14. Acceptance of a gift from an attest client by a member on the engagement team or able to influence the engagement unless the value is clearly insignificant. Acceptance of entertainment from the attest client, or the offer of a gift or entertainment to the attest client, does not impair independence if it is reasonable in the circumstances.

Case Study 6

Situation: Tim Robin is a staff auditor for Woods & Costas, CPAs who is currently working on the Alpha Manufacturing audit engagement. Tim Robin's sister works in the sales department of Alpha Manufacturing.

Independent: Independence is impaired if an individual participating in the audit has a close relative who has a key position with the client. The sales position held by Tim's sister is not a key position. Thus, independence is not impaired. A close relative is defined as a parent, sibling, or nondependent child.

1.300 - General Standards Rule

A member shall comply with the following:

1. Undertake only those services that the member can reasonably expect to complete with *professional competence*.
2. Exercise *due professional care* when performing professional services.
3. Adequately *plan and supervise* performance of professional services.
4. Obtain *sufficient relevant data* to provide a reasonable basis for conclusions in relation to any professional service.

1.310 - Compliance with Standard Rule

A member who performs auditing, review, compilation, management consulting, tax, or other professional services must comply with standards issued by designated bodies (the PCAOB and relevant AICPA committees and boards).

1.320 - Accounting Principle Rule

A member shall not (1) express an opinion, (2) make an affirmative statement about conformity with GAAP, or (3) state that (s)he is not aware of any material modifications that should be made to achieve conformity with GAAP, given any departure from an accounting principle issued by bodies designated to establish such principles by the AICPA Council (the Financial Governmental Accounting Standards Board, Federal Accounting Standards Advisory Board, and International Accounting Standards Board). The departure must have a material effect on the financial statements or data taken as a whole. However, if the member can demonstrate that, due to unusual circumstances, the financial statements or data would have been misleading without a departure from GAAP, the member can comply with the rule by (1) describing the departure; (2) its approximate effects, if practicable; and (3) the reasons compliance with the principle would be misleading.

1.400 - Acts Discreditable Rule

A member shall not commit an act that is discreditable to the profession.

Interpretations

The following list includes Acts Discreditable:

1. Discrimination and Harassment in Employment Practices
2. Solicitation or Disclosure of EPA Questions and Answers
3. Failure to File a Tax Return or Pay a Tax Liability
4. Negligence in the Preparation of Financial Statements or Records

A member shall be considered in violation of the “Acts Discreditable Rule” [1.400.001] if the member, by virtue of his or her negligence, does any of the following:

- a. Makes, or permits or directs another to make, materially false and misleading entries in the financial statements or records of an entity.

- b. Fails to correct an entity's financial statements that are materially false and misleading when the member has the authority to record an entry.
- c. Signs, or permits or directs another to sign, a document containing materially false and misleading information.

5. Not Following Requirements of Government Bodies, Commissions or Other Regulatory Agencies.

A member must follow GAAP and the requirements of governing bodies, commissions, or regulatory agencies when preparing financial statements or related information or in performing attest services for entities subject to their jurisdiction. For example, the SEC and PCAOB have created such requirements. If the member performs attest services related to reports to governing bodies, etc., (s)he must follow the requirements of those bodies as well as GAAS. A material departure from the requirements is an act discreditable unless the member discloses the reasons.

6. Not Applying Government Audits Standards

In a governmental audit, failure to adhere to applicable audit standards, guides, procedures, statutes, rules, and regulations is an act discreditable to the profession unless the report discloses the failure and the reasons therefore.

7. Using Indemnification and Limitation of Liability Provisions

Regulators may prohibit regulated entities from entering into certain kinds of indemnification and limitation of liability agreements in connection with attest services. Regulators also may prohibit members from providing services under such agreements. Failing to comply with such prohibitions is an act discreditable.

8. Failing to Maintain Confidential Information Obtained From Employment or Volunteer Activities

A member should maintain the confidentiality of his or her employer's or firm's (employer) confidential information and should not use or disclose any confidential employer information obtained as a result of an employment relationship, such as discussions with the employer's vendors, customers, or lenders (for example, any confidential information pertaining to a current or previous employer, subsidiary, affiliate, or parent thereof, as well as any entities for which the member is working in a volunteer capacity).

9. False, Misleading, or Deceptive Acts in Promoting or Marketing Professional Services

10. Failing to Properly Use the CPA Credential

A member who fails to follow the accountancy laws, rules, and regulations on use of the CPA credential in any of the jurisdictions in which the CPA practices would be considered to have used the CPA credential in a manner that is false, misleading, or deceptive and in violation of the "Acts Discreditable Rule"

11. Ignoring Requests for Records

Client records must be returned after a client demands them even if fees have not been paid. This ethical standard applies even if the state in which the member practices grants a lien on certain records in his/her possession. *Client-provided records* are "accounting or other records belonging to the client that were provided to the member by or on behalf of the client."

However, "a member's working papers include, but are not limited to, audit programs, analytical review schedules, and statistical sampling results, analyses, and schedules prepared by the client at the request of the member." *Working papers* are the member's property and need not be made available unless required by (a) statute, (b) regulation, or (c) contract.

Client records prepared by the member include accounting and other records (e.g., tax returns, journals, ledgers, and supporting schedules) that the member was engaged to prepare. They may be withheld if fees are due or the engagement is incomplete.

Supporting records contain information not in the client's records, without which its financial information is incomplete. Supporting records, such as entries and related calculations, are produced by the member. They are not otherwise available to the client. Supporting records for an issued work product should be given to the client upon request unless fees are due for that product.

Records also must be given to a client who suffered a loss because of an act of war or natural disaster.

The member may (a) charge a reasonable fee, (b) provide records in any usable form, and (c) retain copies. Moreover, the records provided must be in a requested format only if the engagement was to prepare them in that format.

Compliance with a client's request usually should be within 45 days.

12. Removing Client Files or Proprietary Information From a Firm

A member whose employment was terminated must not take or retain (a) originals or copies (in any format) from the firm's client files or (b) proprietary information without the firm's permission, unless the member has a contractual arrangement with the firm allowing such action.

1.700 - Confidential Client Information Rule

A member in public practice shall not disclose confidential client information without the client's consent. However, this Rule does not affect a CPA's obligations:

1. To discharge his/her professional obligations properly under General Standards or Accounting Principle rules.
2. To comply with a validly issued and enforceable subpoena or summons or with applicable laws and regulations
3. To cooperate in a review of the CPA's professional practice under AICPA or state CPA society or board of accountancy authorization

4. To initiate a complaint with or respond to any inquiry made by the professional ethics division, trial board of the AICPA, or an investigative or disciplinary body of a state society or board of accountancy

A member who withdrew from an engagement because of fraud on a client's tax return should suggest that the successor obtain permission from the client to reveal the reasons for leaving.

A member who prepares a joint tax return should consider both spouses to be clients. If the spouses are undergoing a divorce, the member will not violate confidentiality rules if (s)he releases information to either spouse. But the legal implications should be discussed with an attorney.

Before use of a third party to assist in providing professional services, the member should (a) have a contract with the provider to protect client confidentiality and (b) be reasonably assured that the provider's procedures are sufficient for this purpose. Absent the contract, specific client consent is needed to disclose confidential client information.

1.800 - Form of Organization and Name Rule

A member may practice public accounting only in a form of organization allowed by law or regulation that conforms with resolutions of the AICPA Council.

1. The firm name must not be misleading.
2. Names of past owners may be included in the name of the successor organization.
3. A firm cannot designate itself as "members of the AICPA" unless all CPA owners are members.

Case Study 7

Indicate whether each of the following statements is correct or incorrect.

1. John states that the AICPA's *Code of Professional Conduct* covers principles and rules of conduct. Is John correct?
2. In interpreting the AICPA rules, Nancy determines that the rules of professional conduct are nonbinding, but the principles are binding. Is Nancy correct?
3. Overall, the public interest is not a concern of AICPA members.
4. When performing attestation services, William, an AICPA member, should be independent in both fact and appearance. Correct or incorrect?
5. Sid was working at his client, XYZ company, and met an extremely competent employee of XYZ. Sid decided that in this case, he could subordinate his/her judgment to qualified client experts. Was Sid correct in his decision?
6. In order for Ted to comply with general standards, he must use professional competence, due professional care, adequate planning and supervision, and obtain sufficient relevant data. Is this correct?
7. Although Jeremy felt strongly the circumstances might warrant otherwise, he knew he must never accept a departure from GAAP in the financial statements. Was Jeremy necessarily correct?
8. The Morris company was a longstanding client of Peterson, CPAs. As such, the Peterson firm may never reveal anything about their client's confidential information. Correct or incorrect?

9. In order to create new business for their new practice, Jones and Partners decided to use both print and internet advertising. Is it correct or incorrect that they may advertise.
10. In communicating rules and regulations to new employees, Smith and Partners, CPAs, communicated that the following rules are binding on all members of the AICPA: Integrity and Objectivity, General Standards, Compliance with Standards, Accounting Principles, Acts Discreditable, Commissions and Referral Fees, Form of Organization and Name, and Contingent Fees. Is this correct or incorrect?
11. Serbinski and Partners is jointly owned by several CPAs, EAs and several CFAs. They wish to designate the firm as "members of the AICPA" because they believe that all owners of a firm need not be AICPA members for the firm to designate itself as such. Are they correct?

Answers

1. Incorrect. It also covers interpretations and ethical rulings.
2. Incorrect. The principles of professional conduct are a nonbinding framework. The rules of professional conduct are mandatory.
3. Incorrect. The Public Interest is one of the 6 principles of the AICPA Code of Professional Conduct.
4. Correct. According to the principles of professional conduct, a member should be independent in fact and appearance when providing attestation services.
5. Incorrect. Rule 1.100 states that a member shall maintain objectivity and integrity, be free of conflicts of interest, not knowingly misrepresent facts, and not subordinate his/her judgment to others when performing professional services.
6. Correct. Professional competence, due professional care, adequate planning and supervision, and obtaining sufficient relevant data are required for member compliance with Rule 1.300.
7. Incorrect. According to Rule 1.320, "Accounting Principles," if a member can demonstrate that, due to unusual circumstances, the financial statements or data would be misleading without a departure from GAAP, the member can comply with this rule by describing the departure, its effect, and the reasons compliance with the principle is misleading.
8. Incorrect. A client's confidential information may be disclosed when necessary to comply with a CPA's obligations, including: (1) To comply with a validly issued and enforceable subpoena or summons or with applicable laws and regulations. (2) To discharge his/her professional obligations properly under Conduct Rules 1.310 and 1.320. (3) To cooperate in a review of the CPA's professional practice under AICPA or state CPA society or board of accountancy authorization. (4) To initiate a complaint with or respond to any inquiry made by the professional ethics division, trial board of the AICPA, or an investigative or disciplinary body of a state society or board of accountancy.
9. Correct. Rule 1.600 states that a member in public practice shall not seek to obtain clients by advertising or other forms of solicitation done in a false, misleading, or deceptive manner. Solicitation through coercion, overreaching, or harassing conduct is prohibited.

10. Incorrect. The Rule of Conduct regarding Contingent Fees is binding only on members in public practice. Part of Rule 1.520, *Commissions*, also applies only to members in public practice.
11. Incorrect. According to Rule 1.800, *Form of Organization and Name*, all CPA owners must be AICPA members for the firm to designate itself "members of the AICPA."

Case Study 8

The Case of the Almost Stolen Clients

RULES THAT APPLY:

AICPA Rule 1.600, *Advertising or Other Forms of Solicitation*

THE PLAYERS:

Respondent: Mr. Knotmee

Complaint Submitted by: The Firm

CASE DETAILS:

In a letter to the ICPAS**, The Firm indicated that Mr. Knotmee, a former employee, improperly solicited clients of The Firm after his departure. In particular, The Firm stated that:

- At time of Mr. Knotmee's termination, he was asked to return all copies of any client lists and information. However, he failed to comply with this request.
- Prior to Mr. Knotmee's termination, his personnel file disappeared, which contained the non-compete agreement.
- In a solicitation (marketing) letter, Mr. Knotmee claims to employ current employees of The Firm. However, these employees have stated that they indeed do not work for Mr. Knotmee.
- The Firm disputed some of the claims that Mr. Knotmee made in his marketing letter. Among the disputed claims:
- Mr. Knotmee stated he was a consulting manager at The Firm. - The Firm argued that he was classified as staff.
- Mr. Knotmee stated that he parted company with The Firm on April 15, 20xx. - The Firm stated that Mr. Knotmee was terminated on March 31 on the same year and that the reasons Mr. Knotmee gave for his dismissal are not representative of reality.
- Mr. Knotmee stated that many of The Firm's associates worked in conjunction with Mr. Knotmee's company. - The Firm stated that there are NO employees at The Firm who work for Mr. Knotmee's company.
- In Mr. Knotmee's resume, he stated that he is a member of the AICPA. - The Firm knows this to be false.

The ICPAS contacted Mr. Knotmee to inform him of the complaint made by The Firm, and to request a meeting. In the meeting between Mr. Knotmee and the ICPAS, Mr. Knotmee conceded that he should not have claimed to be member of AICPA since he is not. He stated that it was an oversight and he did not attempt to deceive.

He also was under the impression that it is the responsibility of The Firm to prove advertising material is false. The Ethics Committee informed him that it is the obligation of the member to verify his own advertising materials. Mr. Knotmee supported his fee claims by presenting invoices by The Firm and by other accounting firms. However, since that type of information is confidential, it could not be disclosed, otherwise it would violate another ethics rule.

Mr. Knotmee said that although he has no employees now except himself, the persons he listed on his solicitation letter would work with him on his request. Mr. Knotmee did not receive any clients from the marketing letter. He promised to refrain from soliciting The Firm's clients in the future.

CONCLUSION:

The ICPAS found prima facie evidence that Mr. Knotmee had violated Advertising Rule 1.600.

CORRECTIVE ACTION:

The ICPAS and the AICPA instructed Mr. Knotmee to immediately comply with the ICPAS Code of Professional Conduct, to take and pass the AICPA course, Professional Ethics for CPAs, and to submit evidence that he has passed course.

LESSONS LEARNED:

While we all like to make our resumes as informative as possible, make sure the information is correct, and that you don't pretend to be who you are not. Information that is false, misleading, or deceptive can get you into big trouble!

Case Study 9

The Case of the Harmless Mistakes

RULES THAT APPLY:

AICPA 1.300, *General Standards*
AICPA 1.400, *Acts Discreditable*

THE PLAYERS:

Respondent: Mr. Happy
Complainant: Mr. Grumpus
Client: Company RED

CASE DETAILS:

In a letter to the ICPAS**, Mr. Grumpus indicated that Mr. Happy and his company billed excessively for work done for Company RED that was considered substandard because it contained errors in projected financial statements.

Mr. Grumpus also claimed that the overly aggressive collections method that Mr. Happy used was of low professional conduct. Mr. Happy is a former employee of Mr. Grumpus and his company.

Mr. Happy responded via an interview with the ICPAS and indicated that the error in the projected financial statements was a failure to include the amount of interest expense in the determination of net income. Mr. Happy indicated that the mistake was in the software formula, causing the subtotal not to foot. Mr. Happy said that the error was immaterial. If materiality is based on projected revenue, the errors amounted to less than two percent for each of the three years in question. If it is based on percentage of error on net income, the errors amount to 40%, 15%, and 6% for the same years. Mr. Grumpus relied on the PPC Forecasts and Projections Guide in determining materiality issue. As stated in the PPC guide materiality could be as high as twice that used for the historical financial statements.

Mr. Happy also said that the projected financial statements were not relied upon and that the users were sophisticated financial professionals who caught the error and made manual and mental corrections to the statements. The error had no effect on the complainant's analysis of the projected venture and did not affect their conclusions about not pursuing the venture. The ICPAS investigator contacted Company RED and discovered that had the numbers been correct, the merger would not have been completed anyway due to seller related issues.

Mr. Happy said that an offer to reissue the financial statements was made and that Company RED declined. The ICPAS investigator told Mr. Happy that he should have notified Company RED in writing to state that the financial statements should be reissued.

The second issue concerning unpaid fees is being contested by Company RED as being too high due to excessive hours and credits that have not been applied as stated. Mr. Happy has not issued the billing credit on the advice of legal counsel. The interest charges per the respondent and the complainant have been eliminated from the statements submitted. The ethics committee feels that at this point, the fees should be settled between the parties and will not be an issue in the ethics investigation.

CONCLUSION:

The case was closed with a determination that no violation of the Code of Professional Conduct occurred. In a letter to Mr. Happy, the committee suggested that as a protective measure, he should put in writing any offers to reissue financial reports should such circumstances arise in the future.

CORRECTIVE ACTION:

None.

LESSONS LEARNED:

While fee disputes are a common source of complaints to the Ethics Committee, they generally do not get involved in them. However in this case the Committee debated whether the work product was being relied on. The Committee determined that although the projection was materially flawed, the primary users had discovered the error and took the error into consideration during their negotiations. At this point, the projection was no longer being relied on.

If a document is in error and the accountant knows this, it is the accountant's responsibility to take all efforts to make all users aware of this, typically through recalling a report and reissuing.

However, if the report is not being relied on due to the "staleness" of the document, or the "special purpose" nature of the document having expired, there is no need to recall the report.

Case Study 10

The Case of the Inadequate Accountant

RULES THAT APPLY:

AICPA Rule 1.310, *Compliance with Standards*

AICPA Rule 1.320, *Accounting Principles*

THE PLAYERS:

Respondent: Mr. Indigo

Complainant: Mr. Whiner

Audited Party: Loser Township

CASE DETAILS:

Mr. Indigo performed an audit of the financial statements of the Loser Township for the year ended March 31, 20xx.

Mr. Whiner wrote in a letter to the ICPAS that Mr. Indigo's audit contained major deficiencies. The ICPAS notified Mr. Indigo of the complaint. The ICPAS Ethics Committee investigators met with Mr. Indigo at his office.

At the meeting, Mr. Indigo made the following statements:

- The Loser Township is one of three municipal clients. Their primary practice is in tax and monthly work.
- The firm has not completed a quality review as of yet. The review was scheduled for March 20xx, but was not started. None of the governmental audit work appears to follow yellow book standards. The firm has available to it, the AICPA audit guide Audits of State and Local Governmental Units and referred to it during the audit.
- The firm also utilized a PPC Guide on Auditor's Reports in drafting its report on the Loser Township financial statements.

The following deficiencies were discussed and noted at the meeting:

- The financial statements presented a prior year column that was also audited by Mr. Indigo. However, the auditor's opinion made no reference to the prior year. Other statements were inaccurate or missing.
- Based on review of the footnotes to the financial statements, the following notes were not present:
 - Reporting entity note;
 - Description of funds;
 - Detail on property tax recognition
 - Change of general fixed asset-shown as an exhibit not part of the notes;

- Insurance coverage for cash and investment disclosure;
- Disclosure on interfund transfers.
- The statements, including the footnotes, would not be a complete disclosure and, as such, are not "liftable" as presented.
- The following items were not present in the workpapers:
 - Assessment of Risk
 - Determination of Materiality
 - Evidence of Review
 - Evidence of Planning

CONCLUSION:

The committee found evidence that Mr. Indigo violated the following rules: - Compliance with Standards, and *Accounting Principles*

CORRECTIVE ACTION:

The Committee instructed Mr. Indigo to comply immediately with professional standards applicable to professional service he performs. They also instructed him to complete 16 hours of specified CPE courses within one year, and show evidence of completion.

LESSONS LEARNED:

Don't try to do work that is unfamiliar or new to you. Accounting standards have become very complex and specialized. This accountant mainly did monthly and tax work, and only had a few municipal clients. In a case such as this, he may have been better off referring the municipal client to an auditor with more expertise in this field. Another option is to do a joint venture with another firm that has more experience. The corrective action in this case focused on trying to educate the member in the area in which he had some inadequacy. But remember that all the CPE in the world cannot take the place of experience.

*Special thanks to Dr. Howard A. Kanter of the DePaul University School of Accountancy and the ICPAS Ethics Committee for developing and maintaining the Ethics Case Studies.

** ICPAS refers to Illinois CPA Society

Case Study 11

Bernard Madoff founded the Wall Street firm Bernard L. Madoff Investment Securities LLC in 1960, and was its chairman until his arrest on December 11, 2008. On March 12, 2009, Madoff pleaded guilty to 11 federal felonies and admitted to turning his wealth management business into a massive Ponzi scheme. The Madoff investment scandal defrauded thousands of investors of billions of dollars. Madoff said he began the Ponzi scheme in the early 1990s. However, federal investigators believe the fraud began as early as the mid-1980s and may have begun as far back as the 1970s.

Those charged with recovering the missing money believe the investment operation may never have been legitimate. The amount missing from client accounts, including fabricated gains, was almost \$65 billion. The SIPC trustee estimated actual losses to investors of \$18 billion. On June 29, 2009, Madoff was sentenced to 150 years in prison, the maximum allowed.

In his plea allocution, Madoff stated he began his Ponzi scheme in 1991. He admitted he had never made any legitimate investments with his clients' money during this time. Instead, he said, he simply deposited the money into his personal business account at Chase Manhattan Bank. When his customers asked for withdrawals, he paid them out of the Chase account—a classic "robbing Peter to pay Paul" scenario. Chase and its successor, JPMorgan Chase, may have earned as much as \$483 million from his bank account. He was committed to satisfying his clients' expectations of high returns, despite an economic recession. He admitted to false trading activities masked by foreign transfers and false SEC filings. He stated that he always intended to resume legitimate trading activity, but it proved "difficult, and ultimately impossible" to reconcile his client accounts. In the end, Madoff said, he realized that his scam would eventually be exposed.

On June 29, 2009, Chin sentenced Madoff to the maximum sentence of 150 years in federal prison. Madoff's lawyers originally asked the judge to impose a sentence of 7 years, and later requested that the sentence be 12 years, because of Madoff's advanced age of 71 and his life expectancy.

Madoff apologized to his victims, saying,

"I have left a legacy of shame, as some of my victims have pointed out, to my family and my grandchildren. This is something I will live in for the rest of my life. I'm sorry."

Note: The corporate governance of the Madoff organization was compromised by having all the key players be members of Madoff's family. He employed at the firm his brother Peter, as the Chief Compliance Officer; Madoff's niece was the general counsel and rules compliance attorney, and his sons Andrew and Mark were directors.

Where were the Accountants?

From 1991–2008, Friehling & Horowitz, a little-known accounting firm in New City, New York, a small hamlet in the Rockland County suburbs north of New York City, signed off on audits on Bernard L. Madoff Investment Securities LLC's books. The firm consisted of two principals—David Friehling and Jerome Horowitz—and a secretary. Horowitz met Madoff in 1963, when the Madoff organization was a penny stock trader. He audited Madoff's books before retiring to Palm Beach Gardens, Florida in 1991 and handing the account to his son-in-law, Friehling.

Well before the Madoff scandal broke, several observers doubted that a tiny firm with only one active accountant could competently audit a firm that had grown into a multi-billion-dollar operation.

In 2007, Aksia LLC, a hedge fund consultant, warned its clients to stay away from Madoff for that very reason; its CEO, Jim Vos, likened this situation to General Motors being audited by a three-person firm.

Others were suspicious that Madoff refused requests for due diligence because his accountant—supposedly his brother-in-law—was the only one allowed to see the books.

Prior to the scandal, many contended it was inconceivable that the growing volume of Madoff accounts could be competently and legitimately serviced by his documented accounting/auditing firm, a three-person firm with only one active accountant.

Madoff's firm paid Friehling between \$12,000 and \$14,500 a month for his services between 2004 and 2007, and it was reported that Friehling and his family withdrew millions of dollars from accounts at the Madoff firm, over \$5.5 million since 2000.

- Although required, Friehling was not registered with the Public Company Accounting Oversight Board, which was created under the Sarbanes-Oxley Act of 2002 to help detect fraud.
- According to the AICPA, Friehling was enrolled in their peer-review program, but was not required to participate because he advised the group that he had not conducted audits for 15 years. Peer reviews are required by the AICPA so that auditors check one another for quality control

On March 18, 2009, Friehling was charged with securities fraud, aiding and abetting investment adviser fraud, and four counts of filing false audit reports with the Securities and Exchange Commission.

In a complaint filed in federal court in Manhattan, the SEC alleged that from 1991 through 2008, CPA Friehling and his firm purported to audit financial statements and disclosures of Bernard L. Madoff Investment Securities LLC (BMIS).

James Clarkson, Acting Director of the SEC's New York Regional Office, said, "As we allege in our complaint, Friehling's and F&H's misconduct is egregious. Friehling essentially sold his license to Madoff for more than 17 years while Madoff's Ponzi scheme went undetected. For all those years, Friehling deceived investors and regulators by declaring that Madoff's enterprise had a clean audit record."

The SEC's complaint alleged that Friehling enabled Madoff's Ponzi scheme by falsely stating, in annual audit reports, that F&H audited BMIS financial statements pursuant to Generally Accepted Auditing Standards (GAAS), including the requirements to maintain auditor independence and perform audit procedures regarding custody of securities.

F&H also made representations that BMIS financial statements were presented in conformity with Generally Accepted Accounting Principles (GAAP) and that Friehling reviewed internal controls at BMIS, including controls over the custody of assets, and found no material inadequacies. According to the SEC's complaint, Friehling knew that BMIS regularly distributed the annual audit reports to Madoff customers and that the reports were filed with the SEC and other regulators.

The SEC's complaint alleged that all of these statements were materially false because Friehling and F&H did not perform a meaningful audit of BMIS, and did not perform procedures to confirm that the securities BMIS purportedly held on behalf of its customers even existed.

Instead, Friehling merely pretended to conduct minimal audit procedures of certain accounts to make it seem like he was conducting an audit, and then failed to document his purported findings and conclusions as required under GAAS. If properly stated, those financial statements, along with BMIS related disclosures regarding reserve requirements, would have shown that BMIS owed tens of billions of dollars in additional liabilities to its customers and was therefore insolvent.

According to the SEC's complaint, Friehling similarly did not conduct any audit procedures with respect to BMIS internal controls, and had no basis to represent that BMIS had no material inadequacies. Afraid that his work for BMIS would be subject to peer review, as required of accountants who conduct audits, Friehling lied to the American Institute of Certified Public Accountants for years and denied that he conducted any audit work.

The SEC further alleges that Friehling and F&H obtained ill-gotten gains through compensation from Madoff and BMIS, and also from withdrawing returns from accounts held at BMIS in the name of Friehling and his family members.

He faced up to 105 years in prison on all of the charges.

On November 3, 2009, he pleaded guilty to the charges against him. He admitted to simply rubber-stamping Madoff's filings with the SEC. He also revealed that he continued to audit Madoff even though he had invested a substantial amount of money with him. Accountants aren't allowed to audit broker-dealers with whom they're investing. He agreed to forfeit \$3.18 million in accounting fees and withdrawals from his account with Madoff, as well as his three-story, 4,400-square-foot house in New City and one other property. Friehling faced a maximum sentence of 114 years in prison, but unlike Madoff has agreed to cooperate with the government. The guilty plea effectively ended his career as an accountant; the SEC is not allowed to accept audits from convicted felons. He lost his CPA license on July 19, 2010. Had he gone to trial, he faced over 100 years in prison if convicted.

In May 2015, U.S. District Judge Laura Taylor Swain sentenced Friehling to one year of home detention and one year of supervised release. Friehling avoided prison because he cooperated extensively with federal prosecutors and because he had been unaware of the extent of Madoff's crimes. Addressing the court at the hearing, Friehling apologized to Madoff's victims. Referring to Madoff's reported statement that he was a "dumb auditor," Friehling said: "I would rather be regarded as dumb than crooked. I did not question what I should have questioned."

His role in covering up Madoff's massive Ponzi scheme makes it the largest accounting fraud in history.

Clearly, Friehling violated multiple principles and rules of the AICPA, including:

- *Integrity and Objectivity*: Friehling misrepresented facts, subordinated his judgment, and had a clear conflict of interest. Furthermore, he misled the AICPA with regards to audits and fulfilling the requirements for peer reviews.
- *Independence*: Accountants aren't allowed to audit broker-dealers with whom they're investing, and they are not allowed to provide financial statements for attest clients
- *General Standards Rule, Compliance with Standard Rule, and Accounting Principle Rules*: By failing to perform a proper or adequate audit of the Madoff investment firm, Friehling failed in all regards.

Side Note: In 1999, financial analyst Harry Markopolos informed the SEC that he believed it was legally and mathematically impossible to achieve the gains Madoff claimed to deliver. According to Markopolos, he knew within five minutes that Madoff's numbers did not add up, and it took four hours of failed attempts to replicate them to conclude that Madoff was a fraud. He was ignored by the Boston SEC in 2000 and 2001, as well as by Meaghan Cheung at the New York SEC in 2005 and 2007 when he presented further evidence. He has since published a book, *No One Would Listen*, about the frustrating efforts he and his team made over a ten-year period to alert the government, the industry, and the press about the Madoff fraud.

Chapter 2 Review Questions

1. Which of the following statements best explains why the CPA profession has found it essential to promulgate ethical standards and to establish means for ensuring their observance?
 - A. A distinguishing mark of a profession is its acceptance of responsibility to the public.
 - B. A requirement for a profession is to establish ethical standards that stress primarily a responsibility to clients and colleagues.
 - C. Ethical standards that emphasize excellence in performance over material rewards establish a reputation for competence and character.
 - D. Vigorous enforcement of an established code of ethics is the best way to prevent unscrupulous acts.
2. The AICPA Code of Professional Conduct states, in part, that a CPA should maintain integrity and objectivity. What CPA ability does objectivity in the Code refer to?
 - A. To maintain an impartial attitude on all matters that come under the CPA's review.
 - B. To independently distinguish between accounting practices that are acceptable and those that are not.
 - C. To be unyielding in all matters dealing with auditing procedures.
 - D. To independently choose between alternate accounting principles and auditing standards.
3. Which of the following reports may be issued only by an accountant who is independent of a client?
 - A. Standard report on an examination of a financial forecast.
 - B. Report on consulting services.
 - C. Compilation report on historical financial statements.
 - D. Compilation report on a financial projection.
4. According to Conduct Rule 1.600, *Advertising and Other Forms of Solicitation*, advertising or other forms of solicitation that are false, misleading, or deceptive are NOT in the public interest, and AICPA members in public practice shall NOT seek to obtain clients in such a manner. Such activities include all the following EXCEPT those that _____
 - A. Indicate the CPA's educational and professional attainments.
 - B. Imply the ability to influence a court.
 - C. Claim to be able to save the taxpayer 20% of a determined tax liability.
 - D. Create unjustified expectations of favorable results.
5. When is AICPA Conduct Rule 1.700 violated?
 - A. When a member in public practice provides client profit and loss percentages to a trade association without the client's consent.
 - B. When a member in public practice uses outside computer services to process tax returns.
 - C. When a member in public practice performs consulting services for similar clients.
 - D. When a member in public practice advises potential consulting services clients about previous problems on similar engagements.

Chapter 3

Texas Rules of Professional Conduct

Learning Objectives

After studying this chapter you will be able to:

- Recognize the Texas State Board of Public Accountancy Rules of Professional Conduct.
 - Identify licensing and disciplinary mechanisms for Texas CPAs.
-

History of the Texas State Board²

The Public Accountancy Act (the Act) was originally created in 1915 by the Texas Legislature to form the Texas State Board of Public Accountancy (the Board). The Act mandates the Board to protect the public and ensure competence in the practice of public accountancy by administering examinations, issuing certificates, and by licensing certified public accountants. The policy section of the Act states that the public relies on the strength of the financial system in this state and on the competence, integrity, and expertise of certified public accountants. The Act also restricts the use of the terms “accountant” and “auditor” (and any derivations of those terms) solely to the Board’s licensees. Here are some significant legislative events related to the Act.

In 1945, the Texas Legislature enacted the Public Accountancy Act of 1945. Under this Act, the Board was given the statutory authority to promulgate rules of professional conduct, sometimes referred to as the code of professional ethics. The practice of public accountancy was limited to individuals holding licenses issued by the Board. Anyone holding out as a public accountant or certified public accountant, who was not registered by the Board, was subject to misdemeanor charges and a \$500 fine. “Public Accountants” were authorized, on a one-time basis, to register with the Board.

In 1951, the Texas Legislature amended the Public Accountancy Act of 1945. During the 1950s the Board stepped up its enforcement of the Act and the Rules of Professional Conduct, largely as a result of the failure of several Texas chartered insurance companies. With the statutory authority to do so, the Board began policing the profession for poorly prepared audits and financial statements referred by the State Securities Board, the Texas Education Agency, the Texas Insurance Commission, and others.

In 1961, the Legislature made additional amendments to the Public Accountancy Act of 1945 to strengthen the definition of the “practice of public accountancy.” The amendments delineated exactly those activities that were limited to a licensee of the Board, thus giving the Board leverage in prosecuting individuals for unauthorized practice. And then in several acts from 1979-1989, the Legislature expanded the enforcement authority of the Board even more.

² As provided on the Texas State Board website and monthly Board Reports, <http://www.tsbpa.state.tx.us/general/board-reports.html>

Throughout the rest of this chapter we will look at the specific rules that the Board has enacted to enforce high standards of professional conduct. The rules will be supplemented with case studies and enforcement actions that the Board has taken. The intention is provide you with precise text from the Board, along with supplemental information to help understand real-life situations or nuances.

Rule #	TSBPA RULES OF PROFESSIONAL CONDUCT	Last Amend Date
SUBCHAPTER A: GENERAL PROVISIONS		
501.51	Preamble & General Principles	12/2/2011
501.52	Definitions	6/10/2015*
501.53	Applicability of Rules of Professional Conduct	12/2/2011
501.54	Savings and Provisions and Disposition Table	Repealed 12/2/11
501.55	Definition of Acronyms	12/2/2011
SUBCHAPTER B: PROFESSIONAL STANDARDS		
501.60	Auditing Standards	12/2/2011
501.61	Accounting Principles	10/12/2012
501.62	Other Professional Standards	6/11/2014*
501.63	Financial Statement Standards	4/11/2012
SUBCHAPTER C: RESPONSIBILITIES TO CLIENTS		
501.70	Independence	12/2/2011
501.71	Receipt of Commissions & Other Compensation	12/2/2011
501.72	Contingency Fees	2/17/2008
501.73	Integrity and Objectivity	12/2/2011
501.74	Competence	12/2/2011
501.75	Confidential Client Communications	6/13/2013
501.76	Records and Work Papers	12/2/2011
501.77	Acting Through Others	2/17/2008
501.78	Withdrawal or Resignation	12/2/2011
SUBCHAPTER D: RESPONSIBILITIES TO THE PUBLIC		
501.80	Practice of Public Accountancy	6/10/2015*
501.81	Firm License Requirements	6/10/2015*
501.82	Advertising	12/2/2011
501.83	Firm Names	12/2/2011
501.84	Form of Practice	2/17/2008
501.85	Complaint Notice	12/2/2011
501.86	Disclosure of Subsequently Discovered Facts	Repealed 12/2/11
SUBCHAPTER E: RESPONSIBILITIES TO THE BOARD/PROFESSION		
501.90	Discreditable Acts	10/8/2014*
501.91	Reportable Events	12/2/2011

501.92	Frivolous Complaints	2/17/2008
501.93	Responses	12/2/2011
501.94	Mandatory Continuing Professional Education	10/12/2011

Shaded sections denote rules applicable to CPA's not in client practice

* Denotes update within last 12 months

Texas Rules of Professional Conduct

Recent Changes

Section 501.52 – Definitions

In October of 2014, the AICPA released SSARS 21 with an effective date for engagements on or after 12/15/2015.

AR-C 70 is a new section within SSARS 21 and does the following:

1. Introduces the preparation of financial statements engagement as a new engagement that may be performed separate from a compilation, review or audit engagement
2. Codifies the preparation of financial statements as a non-attest service, and
3. Provides guidance for the preparation of financial engagements that permits an accountant to issue prepared financial statements to a client or third party without a report.

New (6/10/2015):

The section of the Rules covering Definitions has been modified to add the Preparation Engagement introduced in section AR-C 70 of SSARS 21 in the AICPA Code of Professional Conduct.

"Preparation engagement" means the preparation of financial statements that do not include an audit, review or a compilation report on those financial statements in accordance with Standards for Accounting and Review Services adopted by the AICPA.

The Definitions section of the TSBPA Rules has also been modified to include "preparation engagements pursuant to SSARS" in the list of professional accounting services or professional accounting work requiring the specialized knowledge or skills associated with certified public accountants.

Section 501.62 – Other Professional Standards

New (6/11/2014): The list of professional standards to which practitioners must conform was expanded to include:

- A. Statements on Standards for Financial Planning Services (SSFPS)
- B. Statements on Standards for Valuation Services (SSVS).

Section 501.90 – Discreditable Acts

New (10/8/2014): A new act (#8) is added for a conviction or final finding of unethical conduct by state or federal agencies or boards, local governments or commissions for violations of laws or rules on ethics by licensees that engage in activities regulated by those entities including but not limited to: the Public Company Accounting Oversight Board, Internal Revenue Service, U.S. Securities and Exchange Commission, U.S. Department of Labor, U.S. General Accounting Office, U.S. Housing and Urban Development, Texas State Auditor, Texas State Treasurer, Texas Securities Board, Texas Department of Insurance, and the Texas Secretary of State.

Professional Standards

Rule 501.51 Preamble and General Principles

The rules of professional conduct were promulgated under the Public Accountancy Act, which directs the Texas State Board of Public Accountancy to promulgate rules of professional conduct "in order to establish and maintain high standards of competence and integrity in the practice of public accountancy and to insure that the conduct and competitive practices of licensees serve the purposes of the Act and the best interest of the public."

The services usually and customarily performed by those in the public, industry, or government practice of accountancy involve a high degree of skill, education, trust, and experience which are professional in scope and nature.

The use of professional designations carries an implication of possession of the competence associated with a profession. The public, in general, and the business community, in particular, rely on this professional competence by placing confidence in reports and other services of accountants.

The public's reliance, in turn, imposes obligations on persons utilizing professional designations, both to their clients and to the public in general. These obligations include:

- a. Maintaining independence in fact and in appearance, while in the client practice of public accountancy
- b. Continuously improving professional skills,
- c. Observing generally accepted accounting principles and generally accepted auditing standards,
- d. Promoting sound and informative financial reporting,
- e. Holding the affairs of clients in confidence,
- f. Upholding the standards of the public accountancy profession, and
- g. Maintaining high standards of personal and professional conduct in all matters.

The rules are intended to have application to all kinds of professional services **performed in the practice of public accountancy**, including services relating to:

- (1) Accounting, auditing and other assurance services,
- (2) Taxation,
- (3) Financial advisory services,
- (4) Litigation support,
- (5) Internal auditing,
- (6) Forensic accounting, and
- (7) Management advice and consultation.

FYI

Outsourced internal audit services are considered engagements in the client practice of public accountancy as defined in §501.52(8)

The rules also recognize the duty of certified public accountants to refrain from committing acts discreditable to the profession. These acts, whether or not related to the accountant's practice, impact negatively upon the public's trust in the profession.

In the interpretation and enforcement of the rules, the board may consider relevant interpretations, rulings, and opinions issued by the boards of other jurisdictions and appropriate committees of professional organizations, but will not be bound thereby.

Rule 501.52 Definitions

"Act" means the Public Accountancy Act, Chapter 901, Occupations Code;

"Advertisement" means a message which is transmitted to persons by, or at the direction of, a person and which has reference to the availability of the person to perform Professional Accounting Services;

"Affiliated entity" means an entity controlling or being controlled by or under common control with another entity, directly or indirectly, through one or more intermediaries;

"Attest Service" means:

1. An audit or other engagement required by the board to be performed in accordance with the auditing standards adopted by the AICPA, PCAOB, or another national or international accountancy organization recognized by the board;
2. A review or compilation required by the board to be performed in accordance with standards for accounting and review services adopted by the AICPA or another national or international accountancy organization recognized by the board;
3. An engagement required by the board to be performed in accordance with standards for attestation engagements adopted by the AICPA or another national or international accountancy organization recognized by the board; or
4. Any other assurance service required by the board to be performed in accordance with professional standards adopted by the AICPA or another national or international accountancy organization recognized by the board.

"Client" means a party who enters into an agreement with a license holder or a license holder's employer to receive a professional accounting service or professional accounting work;

"Client Practice of Public Accountancy" is the offer to perform or the performance by a person for a client or a potential client of professional accounting services or professional accounting work (see below). It also includes the advice or recommendations in connection with the sale or offer for sale of products (including the design and implementation of computer software), when the advice or recommendations routinely require or imply the possession of accounting or auditing skills or expert knowledge in auditing or accounting, and the performance of litigation support services.

"Licensee" means the holder of a license issued by the board to a person pursuant to the Act, or pursuant to provisions of a prior Act;

"Out of state practitioner and out of state firm" means a person licensed in another jurisdiction practicing in Texas pursuant to a practice privilege as provided for in §901.461 and §901.462 of the Act;

"Person" means an individual, sole proprietorship, partnership, limited liability partnership, limited liability company, corporation or other legally recognized business entity that provides or offers to provide professional accounting services or professional accounting work;

"Practice privilege" means the privilege for an out-of-state person to provide certain Professional Accounting Services or Professional Accounting Work in Texas to the extent permitted under Chapter 517 of the board rules;

"Practice unit" means an office of a firm required to be licensed with the board for the purpose of the client practice of public accountancy;

"Professional Accounting Services" or "professional accounting work" means services or work that requires the specialized knowledge or skills associated with certified public accountants, including:

- (A) issuing reports on financial statement(s);
- (B) preparation engagements pursuant to SSARS
- (C) providing management or financial advisory or consulting services;
- (D) preparing tax returns;
- (E) providing advice in tax matters;
- (F) providing forensic accounting services; and
- (G) providing internal auditing services.

"Preparation Engagement" means the preparation of financial statements that do not include an audit, review or a compilation report on those financial statements in accordance with Standards for Accounting and Review Services adopted by the AICPA.

NOTE

Although not specifically designated in the above definition of professional accounting services, *bookkeeping services* performed/provided by licensees are also considered professional accounting services encompassed by §501.52. This is consistent with the AICPA definition of professional services effective May 31, 2013 in Section 0.400.40 which includes all services performed for a client, an employer, or on a volunteer basis, requiring accountancy or related skills, including but not limited to:

- Accounting
- Audit & other attest services
- Tax
- Bookkeeping
- Management consulting
- Financial management
- Corporate governance
- Personal financial planning
- Business valuation
- Litigation support

- | |
|--|
| <ul style="list-style-type: none">• Educational• All other services for which standards are promulgated |
|--|

"Report" means an opinion, report, or other document, prepared in connection with an attest service that states or implies assurance as to the reliability of financial statement(s); and includes or is accompanied by a statement or implication that the person issuing the opinion, report, or other document has special knowledge or competence in accounting or auditing.

Rule 501.53 Applicability of Rules of Professional Conduct

All of the rules of professional conduct shall apply to and must be observed by a certificate or registration holder engaged in the client practice of public accountancy.

No certificate or registration holder shall issue, or otherwise be associated with, financial statements that do not conform to the accounting principles described in Section 501.61 of this title (relating to Accounting Principles).

The following rules of professional conduct shall apply to and be required to be observed by certificate or registration holders when not employed in the client practice of public accountancy.

Section 501.73 - Integrity and Objectivity

Section 501.74 - Competence

Section 501.77 - Acting through Others

Section 501.78 - Withdrawal or Resignation

Section 501.90 - Discreditable Acts

Section 501.91 - Reportable Events

Section 501.92 - Frivolous Complaints

Section 501.93 - Responses

Section 501.94 - Mandatory Continuing Education Reporting

Rule 501.60 Auditing Standards

An audit is an unbiased examination and evaluation of the financial statements of an organization. Auditors ensure the fiscal accuracy and responsibility of organizations. In doing so, it is critical that auditors stay informed of and follow well-recognized audit standards and practices. Any departures from the standards must be documented and justified.

A person shall not permit his name to be associated with financial statements in such a manner as to imply that he is acting as an auditor with respect to such financial statements, unless he has complied with Generally Accepted Auditing Standards (GAAS) .

Statements on Auditing Standards (SAS) issued by the AICPA, auditing standards included in Standards for Audit of Government Organizations, Programs, Activities and Functions issued by the U.S. GAO, auditing and related professional practice standards to be used by registered public accounting firms issued by the PCAOB, and other pronouncements having similar generally recognized authority, are considered to be interpretations of GAAS.

Case Study 1

Board Investigation Nos: 11-08-24L and 11-08-25L

Rule Violations: 501.60, 501.93, 527.4

After their firm license was expired, the Oldfield firm issued an audit of the Lawrence Water Supply Corporation for the fiscal years that ended December 31, 2008 and 2007 that did not comply with generally accepted auditing standards. The firm was also not in compliance with the Board's rules regarding participation in the mandatory peer review program. Finally, the respondents failed to respond in a timely manner to Board communications dated August 23, 2011, September 27, 2011, November 1, 2011, and December 15, 2011.

Result. This firm violated multiple rules, and the results were fines and review of all future attest work. Respondents entered into an Agreed Consent Order with the Board whereby Respondent Oldfield was suspended for a period of 24 months from the effective date of the Board Order and assessed an administrative penalty of \$15,000 and administrative costs of \$10,000 payable according to a payment schedule in the order. Upon completion of the suspension, Respondents will be subject to a scope limitation until a petition for removal of the limitation is found acceptable to the Technical Standards Review Committee. All attest work performed by Respondents are subject to pre-issuance review.

Rule 501.61 Accounting Principles

Certificate or registration holders in the client practice of public accountancy must follow generally accepted accounting principles (GAAP). If there is a departure from GAAP, the report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with GAAP would result in a misleading statement.

A person, whether or not practicing under a practice privilege as provided for in §901.462 of the Act (relating to Practice by Out-of-State Practitioner With Substantially Equivalent Qualifications), shall not issue a report asserting that financial statements are presented in conformity with GAAP if such financial statements contain any departure from such accounting principles which has a material effect on the financial statements taken as a whole, unless the person, whether or not practicing under a practice privilege, can demonstrate that by reason of unusual circumstances the financial statement(s) would otherwise be misleading.

Case Study 2

Jackson is a sole practitioner CPA in the town of College Station, Texas. He's been running his practice for 25 years, with a wide range of customers. Most of his work is in taxation, with some compilation, and he has done a few audits and reviews in the past. Jackson's interest in accounting has waned, though, with his new love for fly-fishing. He's kept up with changes in the tax code, but not necessarily the latest accounting principles. Recently Jackson expanded his service for an existing client, providing compilation reports, and issued a review report stating that he was not aware of material modifications required in the client's statement, and that they conform to generally accepted accounting principles. However, the client felt something was lacking and took the final report to another accounting firm for a second opinion. Indeed, new accounting firm found significant errors in the accounting for income taxes.

In fact, the new firm felt that Jackson had violated Rule 501.61, and the client was considering filing a complaint with the State Board. When confronted with this feedback, what should Jackson have done?

Solution: Clearly, Jackson should not have taken on new work in an area requiring conformity with GAAP without first getting back up to speed on the material. Regardless of his other interests, his obligation to his clients is paramount. If he didn't want study the latest material, he should have explained upfront to his client that another CPA would be a better fit.

Rule 501.62 Other Professional Standards

In addition to Generally Accepted Auditing Standards (GAAS) and Generally Accepted Accounting Standards (GAAP), the AICPA provides guidance and standards for specific areas of practice. It is important for CPAs to learn these standards and apply them as required.

A person performing other accounting services, such as consulting services, accounting and review services, any other attest service, or tax services shall abide by the professional standards applicable to such services.

Such professional standards are:

1. Statements on Standards on Consulting Services (SSCS);
2. Statements on Standards for Accounting and Review Services (SSARS);
3. Statements on Standards for Attestation Engagements (SSAE);
4. Statements on Standards for Tax Services (SSTS);
5. Statements on Standards for Financial Planning Services (SSFPS);
6. Statements on Standards for Valuation Services (SSVS); or
7. Pronouncements by other professional entities having similar national or international authority recognized by the board.

Case Study 3

Mary, an individually licensed Texas CPA in public practice, does the bookkeeping and prepares the tax returns for a Silicon Valley startup company that recently received \$20 million of private equity financing from a group of venture capitalists. Mary also periodically prepares financial projections and proformas that are used by a third party to generate a valuation of the company for management and the investors.

Q: Is Mary performing any consulting services, accounting and review services, or any other attest service or tax services that would require her to conform to the professional standards of the AICPA or other authoritative body?

A: Yes, the only professional service that Mary is providing that is not required to conform with established professional standards is her bookkeeping service. The tax preparation that she performs for her client must conform with the AICPA's Statement of Standards for Tax Services (SSTS). The financial forecasts and projections are a service that is covered by, and must therefore conform with, the AICPA Statement of Standards for Attestation Engagements (SSAE).

Note: It is a little-known fact that practitioners who issue examinations or compilations or reports on prospective financial statements, or issue examination or review reports on proforma information are subject to compliance

with SSAE #10 as amended by SSAE #11 and #17. This requirement is addressed in the AICPA Professional Standards AT sec 301 and 401.

Rule 501.63 Reporting Standards

A licensee in the client practice of public accountancy must comply with SSARS or another similar standard of a national or international accountancy organization recognized by the board when transmitting a client's financial statements to the client or a third party.

A licensee not employed in the client practice of public accountancy may prepare his employer's financial statements and may issue non-attest transmittals or information regarding non-attest transmittals without a firm license, provided those transmittals do not purport to be in compliance with SSARS or any other similar standard of a national or international accountancy organization recognized by the board.

Important FYI

There is more to Rule 501.63 on Reporting Standards than meets the eye. In developing this standard, and its subsequent revisions, the TSBPA divided the practice of public accountancy into two separate and distinct categories:

- Client Practice – Part (a)
- Industry or Government Practice – Part (b)

The essential difference between Part (a) of this rule and Part (b) is as follows.

Part (a) is referring to the compilation of financial statements by Texas CPA's in public practice as an attest service performed for their Texas clients. (The TSBPA considers compilations to be attest services, even though no opinions/assurances are given as part of the engagement. See Rule 501.52 Definitions – Attest Service #2.)

Part (b) is referring to the compilation of financial statements as a non-attest service performed by employees or other practitioners in industry or government]

The fact that compilation services rendered to Texas-based clients in Part (a) are considered to be attest services has very significant ramifications. A Texas CPA who does a compilation of financial statements, even if for internal use only by management, is still obligated by the TSBPA Rules of Professional Conduct to be ***duly licensed as a Texas CPA firm***, and to perform the compilation in accordance with the Statements on Standards for Accounting and Review Services (SSARS).

This is different from most other accountancy boards, which do not consider compilations to constitute the attest function since a compilation clearly states that no opinion is being expressed.

Case Study 4

Question: Donald Dickens, an individually licensed CPA not licensed as a Texas CPA firm, is being asked by one of his Texas clients to put together financial statements for Olof, Inc. that would not include a number of the

key footnote disclosures that would be required for the statements to comply with GAAP. Under what conditions can Donald prepare the statements without violating the TSBPA Rules of Professional Conduct?

Answer: Donald would be precluded from doing a compilation engagement because the omission of disclosures would violate the Standards for Compilations in SSARS 21. Also, as an individually licensed CPA, Donald does not have the Texas CPA firm licensure required to perform a compilation for the Texas client.

However under the new provisions in SSARS 21 AR-C 70, Donald would be permitted to perform a preparation engagement as an individually licensed CPA as long as the following requirements were met:

- An engagement letter was signed by Donald and the client stipulating that the engagement was for a preparation of the financial statements, not a compilation, review or audit.
- Donald was not required to verify the accuracy or completeness of the information included in the financials.
- A legend was included on each page of the financial statements stating
 - o “No assurance is provided on these financial statements”, or “These financial statements have not been subjected to an audit or review or compilation engagement, and no assurance is provided on them.”
 - o “Substantially all disclosures required by accounting principles generally accepted in the United States Of America are not included”

If these conditions were met, Donald could prepare the financial statements for his client to use internally or to distribute externally.

Responsibilities to Clients

Rule 501.70 Independence

Independence is a vital element for CPAs performing attest functions because it provides the necessary assurances that the CPA will be free from other influences. The Texas State Board of Public Accountancy requires strict compliance with independence rules as set by other professional standard setting bodies.

A person in the performance of professional accounting services or professional accounting work, including those who are not members of the AICPA, shall conform in fact and in appearance to the independence standards established by the AICPA and the board, and, where applicable, the SEC, the U.S. GAO, the PCAOB and other national or international regulatory or professional standard setting bodies.

Increases in the number of multinational audits being performed by U.S. accounting firms means that more CPAs are performing services under the International Federation of Accountants (IFAC) audit and attest standards. Although auditors must comply with the specific standards adopted in each jurisdiction, familiarity with IFAC’s International Ethics Standards Board for Accountants (IESBA) Code of Ethics for Professional Accountants (IESBA Code) in addition to the AICPA Code of Professional Conduct (AICPA Code) is a critical first step. When specifications differ, members should comply with the more restrictive of the applicable standards.

Rule 501.71 Receipt of Commission, Compensation or Other Benefit

To preserve independence, the Rules provide strict guidance for the acceptance of any money or benefit when a CPA recommends or refers a product or service. Any compensation received must be disclosed in writing.

A person shall not for a commission, compensation or other benefit recommend or refer to a client any product or service or refer any product or service to be supplied to a client, or receive a commission, compensation or other benefit when the person also performs services for that client requiring independence.

This prohibition applies during the period in which the person is engaged to perform any of the services requiring independence and during the period covered by any of the historical financial statements involved in such services requiring independence.

A person who receives, expects or agrees to receive, pays, expects or agrees to pay, other compensation in exchange for services or products recommended, referred, or sold by him shall, no later than the making of such recommendation, referral, or sale, disclose to the client in writing the nature, source, and amount, or an estimate of the amount when the amount is not known, of all such other compensation.

This section does not apply to payments received from the sale of all, or a material part, of an accounting practice, or to retirement payments.

Case Study 5

Tim Jenkins, a CPA in Lubbock, Texas, had a very successful practice catering to a number of individuals and small businesses. As an aside, Mr. Jenkins also had an insurance agent license and represented several insurance companies. Tim had an accounting and taxation client who appeared to be in need of more competitive insurance, and Tim was happy to put on his other hat and sign the client up for a policy. Did Tim need to inform his client in writing of any commission in this case because the two services are apparently unrelated.

Solution: Yes, Tim must inform his client in writing of the commission per the Board Rules. In a recent Agreed Consent Order with the Board, a respondent was reprimanded and in addition was required to pay an administrative penalty of \$8,500 and \$137.62 in administrative costs because she had failed to disclose in to clients the nature, source and amount, or an estimate of the amounts, of commissions she received for the sale to clients of insurance and annuity products. Note: Independence rules still apply, so the licensee cannot receive any commissions related to audits, reviews and compilations requiring independence.

Rule 501.72 Contingency Fees

Contingent fees are fees that are determined by a specific result. CPAs may not charge contingent fees where independence is required. As a result, the Rules provide the following specific circumstances where contingent fees are not allowed, or are allowed.

A person shall not perform for a contingent fee any professional accounting services or professional accounting work for, or receive such a fee from, a client for whom the person performs professional accounting services or professional accounting work requiring independence.

A person shall not prepare an original or amended federal, state, local or other jurisdiction tax return for a contingent fee for any client during the period in which the person is engaged to perform any of the services referenced by the section above and the period covered by any historical or prospective financial statements involved in any of the referenced services.

Fees are not contingent if they are fixed by courts or governmental entities acting in a judicial or regulatory capacity, or in tax matters if determined based on the results of judicial proceedings or the findings of governmental agencies acting in a judicial or regulatory capacity, or if there is a reasonable expectation of substantive review by a taxing authority.

A person shall not perform an engagement as a testifying accounting expert for a contingent fee. A testifying accounting expert is one that at any time during the proceeding becomes subject to disclosure and discovery under the procedural rules of the forum where the matter for which his services were engaged is pending.

The prohibitions outlined above apply during any period in which the person is engaged to perform any of the services, and the period covered by any historical or prospective financial statements involved in any of the referenced services.

A consulting accounting expert may become a testifying accounting expert when the client for whom he is working makes his work available to a testifying expert. A consulting accounting expert who is working on a contingent fee basis should work closely with his client to ensure that he does not inadvertently become a testifying expert through the actions of his client. An accounting expert may not accept a contingent fee for part of an engagement and a set fee for part of the same engagement. A consulting accounting expert who becomes a testifying expert may not accept a contingent fee for the part of his work done as a consultant, but must be compensated on a set fee basis for all of the work performed on the same engagement. A consulting accounting expert who enters into a contingent fee engagement should reach an agreement, preferably in writing, with the client as to how he will be compensated should he become a testifying expert prior to beginning the engagement.

Case Study 6

Edward Flint, a CPA in Texas, wanted to grow his business quickly and he knew that in the post-Great Recession period a lot of were tight on money and couldn't necessarily afford the upfront fees for a tax return. Using his sense of marketing, he advertised to potential clients that he would work for 20% fee on any refund he could produce. Is this an acceptable way to get new clients?

Solution: A CPA may not prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client. Edward would clearly be in the wrong in this situation. He can work for clients with tax refunds, but he should do so using a set fee.

Rule 501.73 Integrity and Objectivity

Integrity is the quality of being honest, good character and having strong moral principles. Objectivity means that the CPA must be able to act in an unbiased, neutral way without any prejudice. CPAs must be able to report and

communicate financial statements based on evidence and not on opinions, in order to make the statements reliable, impartial and verifiable.

- a) A person in the performance of professional accounting services or professional accounting work shall maintain integrity and objectivity, shall be free of conflicts of interest and shall not knowingly misrepresent facts nor subordinate his or her judgment to others. In tax practice, however, a person may resolve doubt in favor of his client as long as any tax position taken complies with applicable standards such as those set forth in Circular 230 issued by the IRS and the AICPA's SSTs.
- b) A conflict of interest may occur if a person performs a professional accounting service or professional accounting work for a client or employer and the person has a relationship with another person, entity, product, or service that could, in the person's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the person's objectivity. If the person believes that the professional accounting service or professional accounting work can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, then this rule shall not operate to prohibit the performance of the professional accounting service or professional accounting work because of a conflict of interest.
- c) Certain professional engagements, such as audits, reviews, and other services, require independence. Independence impairments under §501.70 of this chapter (relating to Independence), its interpretations and rulings cannot be eliminated by disclosure and consent.
- d) A person shall not concurrently engage in the practice of public accountancy and in any other business or occupation which impairs independence or objectivity in rendering professional accounting services or professional accounting work, or which is conducted so as to augment or benefit the accounting practice unless these rules are observed in the conduct thereof.

Rule 501.74 Competence

A CPA must not undertake any engagement for professional accounting services which he cannot reasonably expect to complete with due professional competence and compliance with auditing, accounting and other professional standards. The CPA may already have the knowledge required to complete the services with competence prior to performance, or they need additional research or consultation with others during the performance of the professional services.

If a CPA is unable to gain sufficient competence to perform professional accounting services, the CPA shall suggest to the client the engagement of someone competent to perform the needed professional accounting service, either independently or as an associate.

Competent performance includes:

- Exercising due professional care and having necessary technical qualifications.
- Adequately planning, supervising and evaluating the performance and quality of professional services, including that of others.
- Obtaining and maintaining appropriate documentation to afford a reasonable basis for conclusions and recommendations in relation to any professional services performed.

Case Study 7

Scenario 1

James Gant had a small CPA focusing primarily on tax returns and the occasional small business accounting. He was approached by a firm doing work with the government. As part of the firm's contract with the government agencies, they needed to have audits conducted. James felt that this work would be straight-forward with some research on the Internet, so he accepted the job. Was he right to do so?

Solution: James should not have accepted the work because it outside his area of competence, and he could face problems with Rule 501.74 in the future if his work is not up to the necessary standards. In a recent enforcement action by the Board (investigation 11-10-18L), a firm issued an audit of an engineering firm in 2009 that did not adequately support the representations made in the audit report, and the supporting work papers did not comply with Generally Accepted Government Auditing Standards. In addition, the firm falsely claimed an exemption from peer review. To make matters worse, the firm did not timely respond to Board communications. As you can imagine, the Board did not respond favorably to the firm's position. The firm entered into an Agreed Consent Order (ACO) with the Board and received a reprimand. The Board placed his certificate and the firm license on limited scope status until petition for removal could be approved, and the firm was prohibited from performing attest services. Finally, the firm was fined an administrative penalty of \$5,000 and \$9,694.98 in administrative costs.

Rule 501.75 Confidential Client Communications

Except by permission of the client or the authorized representatives of the client, a person or any partner, member, officer, shareholder, or employee of a person shall not voluntarily disclose information communicated to him/her by the client relating to, and in connection with, professional accounting services or professional accounting work rendered to the client by the person. Such information shall be deemed confidential.

The provisions do not prohibit the disclosure of information required by:

- 1) the professional standards for reporting on the examination of a financial statement;
- 2) applicable federal laws, federal government regulations, including requirements of the PCAOB;
- 3) a summons under the provisions of the Internal Revenue Code of 1986 and its subsequent amendments, the Securities Act of 1933 and its subsequent amendments, the Securities Exchange Act of 1934 and its subsequent amendments, or under a court order signed by a judge;
- 4) the public accounting profession in reporting on the examination of financial statements;
- 5) a congressional or grand jury subpoena;
- 6) investigations or proceedings conducted by the Board;
- 7) ethical investigations conducted by a private professional organization of certified public accountants;
or
- 8) in the course of peer reviews.

Case Study 8

Bill is a Texas CPA in the banking industry who has been out of work for some time after completing contract work for Bank A. Eventually, he is approached by the CFO of Bank B (also a Texas CPA) who is interested in hiring him on a temp-to-perm basis provided he will divulge some confidential information about his former employer. Bill agrees to provide the information because:

- a. He no longer has any obligation to his former client
- b. His services to Bank A and Bank B were/are as a temporary contractor, not a full-time employee.
- c. He assumes the information in question, while confidential, is more than likely no longer relevant.

Question 1: What guidance from the AICPA or TSBPA Rules of Professional Conduct should Bill have consulted before making his decision to divulge the confidential information?

Answer:

TSBPA (§501.75): Except by permission of the client or the authorized representatives of the client, a person shall not voluntarily disclose information communicated to him by the client relating to, and in connection with, professional accounting services or professional accounting work rendered to the client.

AICPA: Section 1.700.001 prohibits a member in public practice from disclosing any confidential client information without the specific consent of the client.

Question 2: Are there any circumstances under which Bill could reveal the information without violating the Rules of Professional Conduct?

Answer: Yes. A: AICPA Section 1.700.020.01 states that knowledge and expertise obtained from a prior engagement may be used on behalf of a current client provided that the details of the other engagement are not revealed without permission. If the CFO of Bank B was trying to find out how Bank A calculated loan reserves, Bill could use his knowledge of the methodology to assist Bank B as long as he did not divulge any of Bank A's confidential data used in the calculation method.

If the CFO of Bank was looking for specific data or other information of a confidential nature, Bill could try to locate that information in the public domain. If the information had not been made public, Bill would have to contact Bank A to get permission to discuss the confidential information with Bank B.

Rule 501.76 Records and Work Papers

A CPA must within 10 business days provide a client with the original documents that the client provided the CPA so that the CPA could perform a professional service. Examples of such documents include bank statements and W-2 forms. The CPA cannot charge a fee to return these documents and the documents must be returned to the client upon the client's request, even if the client has not paid the CPA for services rendered. The CPA can keep copies of those documents.

If the CPA previously issued a document to a client, such as a client's tax return or an attest report, the CPA must provide additional copies to the client upon the client's request. The CPA can charge a reasonable fee for providing those copies.

Work papers developed by a CPA during the course of a professional engagement as a basis for, and in support of, an accounting, audit, consulting, tax, or other professional report prepared by the CPA for a client, shall be and remain the property of the CPA who developed the work papers. See Board Rule 501.76(b). Work papers that constitute client records must be provided to the client upon the client's request. Examples of work papers that constitute client records include documents in lieu of books of original entry such as listings and distributions of cash receipts or cash disbursements and consolidating or combining journal entries and documents and supporting detail in arriving at final figures incorporated in an end product such as financial statements or tax returns. A CPA can charge a reasonable fee for providing these documents to a client.

a) Records.

- 1) A person shall return original client records to a client or former client within a reasonable time (promptly, not to exceed 10 business days) after the client or former client has made a request for those records. Client records are those records provided to the person by the client or former client in order for the person to provide professional accounting services to the client or former client. Client records also include those documents obtained by the person on behalf of the client or former client in order for the person to provide professional accounting services to the client or former client. Client records include only the original client documents and do not include the electronic and hard copies that the firm produces. The person shall provide these records to the client or former client, regardless of the status of the client's or former client's account and cannot charge a fee to provide such records. Such records shall be returned to the client or former client in the same format, to the extent possible, that they were provided to the person by the client or former client. The person may make copies of such records and retain those copies.
- 2) A person's work papers, to the extent that such work papers include records which would ordinarily constitute part of the client's or former client's books and records and are not otherwise available to the client or former client, shall also be furnished to the client within a reasonable time (promptly, not to exceed 20 business days) after the client has made a request for those records. The person can charge a reasonable fee for providing such work papers. Such work papers shall be in a format that the client or former client can reasonably expect to use for the purpose of accessing such work papers. Work papers which constitute client records include, but are not limited to:
 - A. documents in lieu of books of original entry such as listings and distributions of cash receipts or cash disbursements;
 - B. documents in lieu of general ledger or subsidiary ledgers, such as accounts receivable, job cost and equipment ledgers, or similar depreciation records;
 - C. all adjusting and closing journal entries and supporting details when the supporting details are not fully set forth in the explanation of the journal entry; and
 - D. consolidating or combining journal entries and documents and supporting detail in arriving at final figures incorporated in an end product such as financial statements or tax returns.

- b) Work papers. Work papers, regardless of format, are those documents developed by the person incident to the performance of his engagement which do not constitute records that must be returned to the client in accordance with subsection (a) of this section. Work papers developed by a person during the course of a professional engagement as a basis for, and in support of, an accounting, audit, consulting, tax, or other professional report prepared by the person for a client, shall be and remain the property of the person who developed the work papers.

- c) For a reasonable charge, a person shall furnish to his client or former client, upon request from his client made within a reasonable time after original issuance of the document in question:
 - 1) a copy of the client's tax return; or
 - 2) a copy of any report or other document previously issued by the person to or for such client or former client provided that furnishing such reports to or for a client or former client would not cause the person to be in violation of the portions of §501.60 of this chapter (relating to Auditing Standards) concerning subsequent events.
- d) This rule imposes no obligation on the person who provides services to a business entity to provide documents to anyone involved with the entity except the authorized representative of the entity.
- e) Documentation or work documents required by professional standards for attest services shall be maintained in paper or electronic format by a person for a period of not less than five years from the date of any report issued in connection with the attest service, unless otherwise required by another regulatory body. Failure to maintain such documentation or work papers constitutes a violation of this section and may be deemed an admission that they do not comply with professional standards.
- f) Interpretive Comment: It is recommended that a person obtain a receipt or other written documentation of the delivery of records to a client.

Case Study 9

Robert Simmons is a sole proprietor CPA with an office in Fort Worth. Lately he has been trying to reduce his workload by downsizing his practice and removing some of his 'trouble' clients. One of these clients, Sam's Service Shop (S3), is consistently late with providing timely documents and with providing payments for services rendered. This tax year was no different; however, things were worse than usual. In the course of completing tax returns for Sam's Service Shop over the years, Robert had to develop depreciation charts and ledgers. Sam's was late as usual with documentation, and Robert decided the time was right to terminate the relationship because Sam's still owed Robert for last year's return. The owner of Sam's was not pleased, said a few nasty things, and demanded every record he had provided Robert along with every journal and work paper Robert made to create the returns. Does Robert need to comply with this demand?

Solution: In addition to any original documents, Robert must provide copies of the papers the work papers that are needed by Sam's to carry on their business with another CPA. As per the Board Rules, though, Robert can charge a reasonable fee for providing these copies.

Note: If a CPA is leaving their current firm, the CPA may not take any work papers associated with any clients of the firm. Absent an agreement between the CPA and her former firm, or between the client and the firm, the client and the work papers developed by the CPA for a firm's client belong to the firm.

Rule 501.77 Acting through Others

A person shall not permit others including non-CPA owners and employees, to carry out on his behalf, either with or without compensation, acts, which, if carried out by the person, would place him in violation of these rules of professional conduct.

The board shall consider that the conduct of any non-CPA owner or employee in connection with the business of a licensed firm is the conduct of that licensed firm for the purposes of the rules of professional conduct.

Rule 501.78 Withdrawal or Resignation

If a person cannot complete an engagement to provide professional accounting services and professional accounting work or employment assignment in a manner that complies with the requirements of this chapter, the person shall withdraw from the engagement or resign from the employment assignment.

If a person withdraws from an engagement or resigns from an employment assignment pursuant to this section, the person shall inform the client or employer of the withdrawal or resignation.

Interpretive Comment: Any withdrawal or resignation shall preferably be in writing. A person shall comply with the requirements of §501.75 (Confidential Client Communications) and §501.90(16) (Discreditable Acts) regarding confidential information of clients and employers during and after a withdrawal or resignation executed pursuant to this section. For purposes of this section, an engagement commences once an engagement letter is signed by the client, time is charged to the engagement, or compensation is received by a person in connection with an engagement or employment assignment.

Responsibilities to the Public

Rule 501.80 Practice of Public Accountancy

A person may not engage in the practice of public accountancy unless he holds a valid license or qualifies under a practice privilege.

A person may not use the title or designation "certified public accountant," the abbreviation "CPA," or any other title, designation, word, letter, abbreviation, sign, card, or device tending to indicate that the person is a CPA unless he holds a valid license issued by the board or qualifies under a practice privilege. A license is not valid for any date or for any period prior to the date it is issued by the board and it automatically expires and is no longer valid after the end of the period for which it is issued.

Any licensee of this board in good standing as a CPA or public accountant may use such designation whether or not the licensee is in the client, industry, or government practice of public accountancy. However, a licensee who is not in the client practice of public accountancy may not in any manner, through use of the CPA designation or otherwise, claim or imply independence from his employer or that the licensee is in the client practice of public accountancy.

Case Study 10

As highlighted in the Board's Orders from July 2013, a Ms. Garcia provided potential clients with business cards entitled "Garcia and Associates, Accounting and Income Tax Services". On her website, she offered services in the use of accounting and tax services. Several clients engaged her services, believing that she was a CPA, licensed with the state. Later, however, they found upon checking the State Board site that Sandra was not listed as a licensed accountant. What should the clients do?

Solution: The clients can simply contact the State Board website to verify this information. The State Board defines the "practice of public accountancy" to include the performance or offer of performance for a client or potential client by a person who represents to the public that the person is certified, licensed, or registered by the Board of a service that involves the use of accounting, attesting, or auditing skills. In this case, the State Board issued a cease and desist order to Ms. Garcia. Ms. Garcia did not change her website, and later the Board assessed a \$10,000 administrative penalty. The clients should seek the services of a licensed CPA, always double-checking the State Board site for confirmation.

Rule 501.81 Firm License Requirements

- a) A firm, may not provide or offer to provide attest services or use the title "CPA," "CPAs," "CPA Firm," "Certified Public Accountants," "Certified Public Accounting Firm," or "Auditing Firm" or any variation of those titles unless the firm holds a firm license issued by the board or qualifies under a practice privilege. A firm license is not valid for any date or for any period prior to the date it is issued by the board and it automatically expires and is no longer valid after the end of the period for which it is issued. A firm license does not expire when the application for license renewal is received by the board prior to its expiration date. An expiration date for a firm license may be extended by the board, in its sole discretion, upon a demonstration of extenuating circumstances that prevented the firm from timely applying for or renewing a firm license.
- b) A firm is required to hold a license issued by the board if the firm establishes or maintains an office in this state.
- c) A firm is required to hold a license issued by the board and an individual must practice through a firm that holds such a license, if for a client that has its principal office in this state, the individual performs:
 - 1) a financial statement audit or other engagement that is to be performed in accordance with SAS;
 - 2) an examination of prospective financial information that is to be performed in accordance with SSAE; or
 - 3) an engagement that is to be performed in accordance with auditing standards of the PCAOB or its successor.
- d) Each advertisement or written promotional statement that refers to a CPA's designation and his or her association with an unlicensed entity in the client practice of public accountancy must include the disclaimer: "This firm is not a CPA firm." The disclaimer must be included in conspicuous proximity to the name of the unlicensed entity and be printed in type not less bold than that contained in the body of the advertisement or written statement. If the advertisement is in audio format only, the disclaimer shall be clearly declared at the conclusion of each such presentation.
- e) The requirements of subsection (d) of this section do not apply with regard to a person performing services:
 - 1) as a licensed attorney at law of this state while in the practice of law or as an employee of a licensed attorney when acting within the scope of the attorney's practice of law;
 - 2) as an employee, officer, or director of a federally-insured depository institution, when lawfully acting within the scope of the legally permitted activities of the institution's trust department; or
 - 3) pursuant to a practice privilege.
- f) On the determination by the board that a person has practiced without a license or through an unlicensed firm in violation of subsection (d) of this section, the person's certificate shall be subject to revocation and may not be reinstated for at least 12 months from the date of the revocation.

- g) Interpretive Comment: A person who is employed by an unlicensed firm that offers services that fall within the definitions of the client practice of public accountancy as defined in §501.52(8) and (22) (relating to Definitions) and §901.003 of the Act (relating to Practice of Public Accountancy) must comply with the disclaimer requirement found in subsection (d) of this section.

Case Study 11

It is the middle of tax season, and Walter Perkins has been too busy to renew license at the State Board website. It is now overdue by two months. What should Walter do?

Solution: Walter must immediately contact the State Board and fulfill all license requirements. His license can be revoked by the Board and fines can be assessed. It is better to extend the returns while he renews his license. Note: Nearly every month the Board reports on CPAs who have not renewed their license – do not be one of them. For instance, in May a CPA received an administrative penalty of \$500 and \$214.85 in administrative costs and a reprimand.

Rule 501.82 Advertising

For many years, CPAs along with other professional groups were not allowed to advertise for clients – they needed to rely upon word of mouth and references. Today, CPAs can advertise but there are very strict rules about what claims the CPA can make.

- a) A person shall not use or participate in the use of:
- 1) any communication having reference to the person's professional services that contains a false, fraudulent, misleading or deceptive statement or claim; nor
 - 2) any communication that refers to the person's professional services that is accomplished or accompanied by coercion, duress, compulsion, intimidation, threats, overreaching, or vexatious or harassing conduct.
- b) Definitions:
- 1) A "false, fraudulent, misleading or deceptive statement or claim" includes, but is not limited to, a statement or claim which:
 - A. contain a misrepresentation of fact;
 - B. is likely to mislead or deceive because it fails to make full disclosure of relevant facts;
 - C. is intended or likely to create false or unjustified expectations of favorable results;
 - D. implies educational or professional attainments or licensing recognition not supported in fact;

- E. represents that professional accounting services can or will be completely performed for a stated fee when this is not the case, or makes representations with respect to fees for professional accounting services that do not disclose all variables that may reasonably be expected to affect the fees that will in fact be charged;
 - F. contains other representations or implications that in reasonable probability will cause a reasonably prudent person to misunderstand or be deceived;
 - G. implies the ability to improperly influence any court, tribunal, regulatory agency or similar body or official due to some special relations;
 - H. consists of self-laudatory statements that are not based on verifiable facts;
 - I. makes untrue comparisons with other accountants; or
 - J. contains testimonials or endorsements that are not based upon verifiable facts.
- 2) Broadcast--Any transmission over the airwaves or over a cable, wireline, Internet, cellular, e-mail system or any other electronic means.
 - 3) Coercion--Compelling by force so that one is constrained to do what his free will would otherwise refuse.
 - 4) Compulsion--Driving or urging by force or by physical or mental constraint to perform or forbear from performing an act.
 - 5) Direct personal communication--Either a face-to-face meeting or a conversation by telephone.
 - 6) Duress--Any conduct which overpowers the will of another.
 - 7) Harassing--Any word, gesture, or action which tends to alarm and verbally abuse another person.
 - 8) Intimidation--Willfully to take, or attempt to take, by putting in fear of bodily harm.
 - 9) Overreaching--Tricking, outwitting, or cheating anyone into doing an act which he would not otherwise do.
 - 10) Threats--Any menace of such a nature and extent as to unsettle the mind of anyone on whom it operates, and to take away from his acts that free and voluntary action which alone constitutes consent.
 - 11) Vexatious--Irritating or annoying.
- c) It is a violation of these rules for a person to persist in contacting a prospective client when the prospective client has made known to the person, or the person should have known the prospective client's desire not to be contacted by the person.
 - d) In the case of an electronic or direct mail communication, the person shall retain a copy of the actual communication along with a list or other description of parties to whom the communication was distributed. Such copy shall be retained by the person for a period of at least 36 months from the date of its last distribution.
 - e) Subsection (d) of this section does not apply to anyone when:
 - 1) the communication is made to anyone who is at that time a client of the person;
 - 2) the communication is invited by anyone to whom it was made; or
 - 3) the communication is made to anyone seeking to secure the performance of professional accounting services.
 - f) In the case of broadcasting, the broadcast shall be recorded and the person shall retain a recording of the actual transmission for at least 36 months.

Case Study 12

Scenario: Tom Williams, a CPA in Houston, recently set up a practice and is now trying to grow the business. His funds are limited, so he plans to promote his sole practice using social media, building off an extensive network he has developed on Facebook and LinkedIn. However, he is concerned that it may violate advertising rules with Texas State Board. How should he proceed?

Solution: Texas accountancy firms may use websites such as LinkedIn, Twitter, and Facebook, so long as they comply with all relevant rules and regulations. Per the rules, Tom must not use any written communication that reference his services and contain a false, fraudulent, misleading or deceptive claim. Tom should be careful about any statements or claims he makes on social media sites. For instance, Tom must not promote any specific experience in auditing, for example, if his practice has only focused on taxation and accounting. Also, Tom's online presence must not violate the Board's rules concerning prohibiting unwanted solicitation of perspective clients. Finally, because social media sites are a form of electronic communication, all records of communication to non-clients must be retained for at least 36 months. Note: The State Board has specifically stated that "self-laudatory statements that are not based on verifiable facts" are not acceptable, and the State Board does not recognize any specializations in public accountancy. Therefore, Tom should be very careful to using any description of himself or his practice as a 'specialist'.

Case Study 13

Samuel Jacobs, CPA, wanted to boost his business so he decided to try more advertising. His first attempt was to publish a short brochure with which he could create a direct mail piece. As part of the copy in the brochure, Samuel stressed 'Always the lowest fee.' Also, Samuel stressed how his close relationship with local IRS office would 'guarantee the best results'. Samuel sent one direct mail. Timothy, another CPA in the area, saw the advertisement and complained to the Board, stating that Samuel ad was deceptive and that Samuel should not be contacting Timothy's clients with such a 'harassing and vexatious' document. Did Samuel violate any rules?

Solution: Yes, Samuel violated the advertising rule. First, the claim of the 'always the lowest fees' could be viewed as a deceptive claim, claiming an unsubstantiated fact. Samuel would be better off using a phrase like 'Great service at a low fee' to reduce this possibility. Second, hinting or stating that a relationship with an IRS office is clearly a violation because it "implies the ability to improperly influence any court, tribunal, regulatory agency or similar body or official due to some special relations". Lastly, the final accusation of harassment is not likely a valid point, unless Samuel continued to send brochures to people who had requested not to be contacted anymore.

Rule 501.83 Firm Names

General rules applicable to all firms:

- 1) A firm name may not contain words, abbreviations or other language that are misleading to the public, or that may cause confusion to the public as to the legal form or ownership of the firm.
- 2) A firm licensed by the board may not conduct business, perform or offer to perform services for or provide products to a client under a name other than the name in which the firm is licensed.

- 3) A word, abbreviation or other language is presumed to be misleading if it:
 - A. is a trade name or assumed name that does not comply with paragraph (4)(a) or (b) of this subsection;
 - B. states or implies the quality of services offered, special expertise, expectation as to outcomes or favorable results, or geographic area of service;
 - C. includes the name of a non-owner of the firm;
 - D. includes the name of a non-CPA, except as provided in paragraph (4)(B) of this subsection;
 - E. states or implies educational or professional attainment not supported in fact;
 - F. states or implies licensing recognition for the firm or any of its owners not supported in fact; or
 - G. includes a designation such as "and company," "company," "associates," "and associates," "group" or abbreviations thereof or similar designations implying that the firm has more than one employed licensee unless there are at least two employed licensees involved in the practice. Independent contractors are not considered employees under this subsection.
- 4) A word, abbreviation or other language is presumed not misleading if it:
 - A. is the name, surname, or initials of one or more current or former CPA owners of the firm, its predecessor firm or successor firm;
 - B. is the name, surname, or initials of one or more current or former foreign practitioner owners of the firm, its predecessor firm or successor firm who are or would have been eligible to practice public accountancy in this state under §513.2 of this title (relating to Application for Registration of Foreign Practitioners);
 - C. indicates the legal organization of the firm; or
 - D. states or implies a limitation on the type of service offered by the firm, such as "tax," "audit" or "investment advisory services," provided the firm in fact principally limits its practice to the type of service indicated in the name.
- 5) The board may place conditions on the licensing of a firm in order to ensure compliance with the provisions of this section.

Additional Requirements Based on Legal Form or Ownership.

- 1) The names of a corporation, professional corporation, limited liability partnership, professional limited liability company or other similar legal forms of ownership must contain the form of ownership or an abbreviation thereof, such as "Inc.," "P.C.," "L.L.P." or "P.L.L.C."; except that a limited liability partnership organized before September 1, 1993 is not required to utilize the words "limited liability partnership" or any abbreviation thereof.
- 2) Sole Proprietorships:
 - A. The name of a firm that is a sole proprietor must contain the surname of the sole proprietor as it appears on the individual license issued to the sole proprietor by the board.
 - B. A partner surviving the death of all other partners may continue to practice under the partnership name for up to two years after becoming a sole proprietor, notwithstanding subsection (d) of this section.

- a) The name of any current or former owner may not be used in a firm name during any period when such owner is prohibited from practicing public accountancy and prohibited from using the title "certified public accountant," "public accountant" or any abbreviation thereof, unless specifically permitted by the board.
- b) A firm licensed by the board is required to report to the board any change in the legal organization of the firm and amend the firm name to comply with this section regarding firm names for the new organization within thirty days of the effective date of such change.
- c) This section regarding firm names does not affect firms licensed by the board prior to the effective date of this section, but does apply to any change in legal organization or name that occurs after the effective date of this section. Nothing in this subsection prohibits the board from placing conditions on the licensing of a firm pursuant to subsection (a)(5) of this section at the time of renewal of the firm license.

Case Study 14

Janice Stevens was in a partnership with Eleanor Green for 30 years in the Austin area, practicing under the name of Green & Stevens LLP. Unexpected, Eleanor passed away and Janice found herself practicing alone. However, due to the years of goodwill built-up, not to mention the numerous references to the partnership on the website, telephone books, stationary, etc., Janice wanted to maintain the partnership name. Can she do this indefinitely?

Solution: According the State Board Rules, Janice may keep the partnership name. However, there is a time limit when a partnership becomes a sole proprietorship. Per the rules, a partner surviving the death of all other partners may continue to practice under the partnership name for up to two years. So, Janice will need to change out all the material to reflect this change over the next two years. She'll be able to retain Eleanor's goodwill while she transitions the business name to the sole proprietorship status.

Rule 501.84 Form of Practice

A person may practice public accountancy only in a sole proprietorship, partnership, limited liability partnership, limited liability company, corporation or other legally recognized business entity that provides professional accounting services or professional accounting work, organized under the laws of the State of Texas or an equivalent law of another jurisdiction, or as an employee of one of these entities.

Case Study 15

Summary Case Study: Rules 501.80 – 501.84

Tammy Martin is a conscientious Texas CPA who understands that individual CPAs in the client practice of public accountancy are prohibited from performing financial statement audits unless they do so through a firm licensed and registered with the TSBPA. She therefore limits her small practice, which employs two independent contractors, to generating prospective financial information for her clients. To emphasize her expertise as a sole practitioner in that limited area of practice, her business card reads as follows:

Experts in Financial Forecasting

Tammy & Company, CPAs
8883 Rolling Rock Drive #1212
Austintacious, Texas 77001
512-444-9898

Not a CPA Firm

Question 1: Is Tammy in violation of any of the TSBPA Rules of Professional Conduct?

Answer: Yes, Tammy's business card presents numerous violations of the Rules:

- Rule 501.83: The name of a firm that is a sole proprietor must contain the surname of the sole proprietor as it appears on the individual license issued to the sole proprietor by the board.
- Rule 501.83: The names of a corporation, professional corporation, limited liability partnership, professional limited liability company or other similar legal forms of ownership must contain the form of ownership or an abbreviation thereof, such as "Inc.," "P.C.," "L.L.P." or "P.L.L.C"
- Rule 501.81: The disclaimer, which should read "This firm is Not a CPA Firm", is not in conspicuous proximity to the firm name.
- Rule 501.83: A word, abbreviation or other language is presumed to be misleading if it includes a designation such as "and company," "company," "associates," "and associates," "group" or abbreviations thereof or similar designations implying that the firm has more than one employed licensee unless there are at least two employed licensees involved in the practice. Independent contractors are not considered employees.
- Rule 501.82: The representation "Experts in Financial Forecasting" above the firm name is presumed to be misleading if it states or implies the quality of services offered, special expertise, expectation as to outcomes or favorable results, or geographic area of service.

Question 2: If the only service offered by Tammy's firm was bookkeeping, would she still need to show a disclaimer?

Answer: Yes. If non-attest services that are deemed to be professional accounting work in the client practice of public accountancy are provided to a Texas-based client by an entity without a Texas firm license, the disclaimer is required. In the Definitions section of the TSBPA Rules of Professional Conduct, bookkeeping services performed/provided by licensees are considered professional accounting services encompassed by §501.52.

Rule 501.85 Complaint Notice

When a person receives a complaint that an alleged violation of the Act or Rules of Professional Conduct has occurred, a person shall provide to the complainant a statement that: Complaints concerning Certified Public

Accountants may be addressed in writing to the Texas State Board of Public Accountancy at 333 Guadalupe, Tower 3, Suite 900, Austin, Texas 78701-3900, telephone (512) 305-7866, e-mail to enforcement@tsbpa.state.tx.us, or fax (512) 305-7854.

Responsibilities to the Board/Profession

Rule 501.90 Discreditable Acts

The following is a specific list of discreditable acts found in the TSBPA Rules of Professional Conduct. The list is included to provide a section of violations without needed to include separate rules throughout the rest of the rules. The Board may discipline a member for violating one of these acts, even though the act was not previously listed in the Code.

A person shall not commit any act that reflects adversely on that person's fitness to engage in the practice of public accountancy. A discreditable act includes but is not limited to:

1. Fraud or deceit in obtaining a certificate as a CPA or in obtaining registration under the Act or in obtaining a license to practice public accounting;
2. Dishonesty, fraud or gross negligence in the practice of public accountancy;
3. Violation of any of the provisions of Subchapter J or §901.458 of the Act (relating to Loss of Independence) applicable to a person certified or registered by the board;
4. Final conviction of a felony or imposition of deferred adjudication or community supervision in connection with a criminal prosecution of a felony under the laws of any state or the United States;
5. Final conviction of any crime or imposition of deferred adjudication or community supervision in connection with a criminal prosecution, an element of which is dishonesty or fraud under the laws of any state or the United States, a criminal prosecution for a crime of moral turpitude, a criminal prosecution involving alcohol abuse or controlled substances, or a criminal prosecution for a crime involving physical harm or the threat of physical harm;
6. Cancellation, revocation, suspension or refusal to renew authority to practice as a CPA or a public accountant by any other state for any cause other than failure to pay the appropriate registration fee in such other state;
7. Suspension or revocation of or any consent decree concerning the right to practice before any state or federal regulatory or licensing body for a cause which in the opinion of the board warrants its action;
8. A conviction or final finding of unethical conduct by state or federal agencies or boards, local governments or commissions for violations of laws or rules on ethics by licensees that engage in activities regulated by those entities including but not limited to: the Public Company Accounting Oversight Board, Internal Revenue Service, U.S. Securities and Exchange Commission, U.S. Department of Labor, U.S. General Accounting Office, U.S. Housing and Urban Development, Texas State Auditor, Texas State Treasurer, Texas Securities Board, Texas Department of Insurance, and the Texas Secretary of State.
9. Knowingly participating in the preparation of a false or misleading financial statement or tax return;
10. Fiscal dishonesty or breach of fiduciary responsibility of any type;
11. Failure to comply with a final order of any state or federal court;
12. Repeated failure to respond to a client's inquiry within a reasonable time without good cause;
13. Intentionally misrepresenting facts or making a misleading or deceitful statement to a client, the board, board staff or any person acting on behalf of the board;

14. Giving intentional false sworn testimony or perjury in court or in connection with discovery in a court proceeding or in any communication to the board or any other federal or state regulatory or licensing body;
15. Threats of bodily harm or retribution to a client;
16. Public allegations of a lack of mental capacity of a client which cannot be supported in fact;
17. Voluntarily disclosing information communicated to the person by an employer, past or present, or through the person's employment in connection with accounting services rendered to the employer, except:
 - A. By permission of the employer;
 - B. Pursuant to the Government Code, Chapter 554 (commonly referred to as the "Whistle Blowers Act");
 - C. Pursuant to court order, summons, congressional or grand jury subpoena, or applicable federal laws, federal government regulations, including requirements of the PCAOB;
 - D. In an investigation or proceeding by the board;
 - E. In an ethical investigation conducted by a professional organization of CPAs;
 - F. In the course of a peer review under §901.159 of the Act (relating to Peer Review); or
 - G. Any information that is required to be disclosed by the professional standards for reporting on the examination of a financial statement.
18. Breaching the terms of an agreed consent order entered by the board or violating any Board Order.

Interpretive Comment: The board has found in §519.7 of this title (relating to Misdemeanors that Subject a Licensee or Certificate Holder to Discipline by the Board) and §525.1 of this title (relating to Applications for the Uniform CPA Examination, Issuance of the CPA Certificate, or a License) that any crime of moral turpitude directly relates to the practice of public accountancy. A crime of moral turpitude is defined in this chapter as a crime involving grave infringement of the moral sentiment of the community. The board has found in §519.7 of this title that any crime involving alcohol abuse or controlled substances directly relates to the practice of public accountancy.

Case Study 16

Board Complaint No. 13-05-10L, September 9, 2013

Background: Ms. Snyder was director of finance for the Aids Foundation of Houston and accused indicted for embezzling more than \$120,000 between February 20, 2007 and March 4, 2010.

Finding of Fact by the Board: On December 12, 2012, Ms. Snyder was convicted of a 1st degree felony for theft of property greater than or equal to \$200 ,000 and sentenced to 1 0 years in prison. A complaint was filed against Respondent on August 7, 201 2, and she was provided with the opportunity to respond to the complaint and to show compliance with the law.

Conclusions of Law: The actions as set forth in Finding of Fact constitute violations of 501.90(4), which states that a person shall not commit any act that reflects adversely on that person's fitness to engage in the practice of public accountancy; specifically, final conviction of a felony or imposition of deferred adjudication or community supervision in connection with a criminal prosecution of a felony under the laws of any state or the United States. The actions as set forth in Finding of Fact (2) constitute violations of the following Sections of the Act: 901.502(6) regarding a violation of the Rules of Professional Conduct; 901.502(10), regarding a final conviction

of or the imposition of deferred adjudication for an offense under the laws of any state or the United States that is a felony; and 901.502(11), regarding conduct indicating a lack of fitness to serve the public as a professional accountant.

Orders: Upon ratification of this ACO by the Board, Respondent's certificate as a Certified Public Accountant will be revoked in lieu of further disciplinary action. Within 30 days of the Board Order Respondent must return the original certificate to the Board's Enforcement Division. Respondent may not represent herself to be a Certified Public Accountant. Respondent's firm may not represent itself to be a CPA, Accounting or Auditing firm. Respondent may not perform or issue audits or any attestations. If Respondent makes prohibited representations or perform any of the services that require a certificate and licenses to perform, the Board will request that a Cease-and-Desist Order be issued against Respondent by an Administrative Law Judge. If Respondent continues the representation or perform any of the prohibited services, the Board will request that a District Court find Respondent in contempt of the Cease-and-Desist Order. Respondent also had to pay an administrative cost of \$111.07.

Other Enforcement Actions from the Board for 501.90

<p>Investigation N: 11-09-09L September 2012</p>	<p>Respondent was suspended by the IRS for at least 40 months from May 26, 2011, for the willful failure to timely file federal income tax returns for 2004 and 2005 and for failure to file federal income tax returns for 2006 and 2007.</p> <p>Respondent entered into an Agreed Consent Order with the Board whereby Respondent was placed on probated suspension for a period of 40 months beginning on September 20, 2012. In addition, Respondent must pay \$2,000 in administrative penalties within 30 days of the date of the Board order.</p>
<p>Investigation No.: 12-01-21L September 2012</p>	<p>Respondent pled guilty to one count of making a false statement to government officials in violation of 18 U.S.C. §1001, a felony offense. Respondent told government officials that he was unaware of a payment made on his behalf to his former employer (Respondent once worked as Controller and Financial and Operations Principle for a company regulated by the NASD), when in fact his attorney made a payment of \$49,350 to his former employer in order to compensate the former employer for monies Respondent converted to his own use.</p> <p>Respondent entered into an Agreed Consent Order with the Board whereby Respondent's certificate was revoked.</p>
<p>Investigation No.: 12-07-15L September 2012</p>	<p>Respondent entered into a deferred adjudication agreement regarding a third degree felony.</p> <p>Respondent entered into an Agreed Consent Order with the Board whereby the Board accepts Respondent's involuntary surrender of his certificate in lieu of further disciplinary proceedings.</p>
<p>Investigation No.: 13-08-05L March 2014</p>	<p>Respondent pleaded guilty and was subject to two (2) years deferred adjudication for selling unregistered securities, a felony.</p>

	Respondent entered into an Agreed Consent Order with the Board whereby Respondent's certificate was revoked for a period of two (2) years from the effective date of the order. However, the revocation was stayed, and Respondent was placed on probation for two (2) years under the following conditions: 1) Respondent must pay \$184.01 in administrative costs within 30 days of the date of the Board Order; and, 2) Respondent shall comply with all state and federal laws pertaining to the practice of public accountancy.
Investigation No: 13-05-41L March 2014	<p>Respondents failed to report the results of a peer review as required by a Board Order and failed to respond to Board communications.</p> <p>Respondents entered into an Agreed Consent Order with the Board whereby Respondents were reprimanded and placed on Limited Scope Status until permission for removal is approved by the Board. In addition, Respondents must pay an administrative penalty of \$4,000 and \$102.85 in administrative costs within 30 days of the date of the Board Order.</p>
Investigation No.: 13-05-19L March 2014	<p>Respondent pleaded guilty to possession of a controlled substance, a felony, and received two (2) years deferred adjudication.</p> <p>Respondent entered into an Agreed Consent Order with the Board whereby Respondent's certificate was revoked for a period of two (2) years from the date of the Board Order. However, the revocation was stayed, and Respondent was placed on probation for two (2) years under the following conditions: 1) Respondent must pay \$141.39 in administrative costs within 30 days of the date of the Board Order; and, 2) Respondent shall continue participation in a treatment program and counseling with a counselor approved by the Executive Director until the counselor reports in writing to the Board that treatment is no longer necessary. Respondent's counselor shall submit quarterly reports to the Board detailing Respondent's progress and confirming Respondent's continued participation in the treatment program.</p>

Rule 501.91 Reportable Events

If a CPA has been involved in an event that has resulted in adverse findings that cannot be appealed, they must report this to the Board within 30 days of the final resolution of the case. In addition, all CPAs must complete the question regarding convictions on their annual renewal and sign the form to complete the renewal and receive the license.

Failure to do so means the renewal is incomplete and the license will not be issued until missing information is provided, and that in turn means the CPA is no longer in good standing and may not practice public accountancy or hold out as a CPA until the matter is resolved. Review the complete list of reportable event below.

- a) A licensee or certificate holder shall report in writing to the board the occurrence of any of the following events within 30 days of the date the licensee or certificate holder has knowledge of these events:
 1. The conviction or imposition of deferred adjudication of the licensee or certificate holder of any of the following:

- A. a felony;
 - B. a crime of moral turpitude;
 - C. any crime of which fraud or dishonesty is an element or that involves alcohol abuse or controlled substances; and
 - D. any crime related to the qualifications, functions, or duties of a public accountant or CPA, or to acts or activities in the course and scope of the practice of public accountancy or as a fiduciary;
2. The cancellation, revocation, or suspension of a certificate, other authority to practice, or refusal to renew a certificate or other authority to practice as a CPA or a public accountant, by any state, foreign country or other jurisdiction;
 3. The cancellation, revocation, or suspension of the right to practice as a CPA or a public accountant before any governmental body or agency or other licensing agency;
 4. An unappealable adverse finding in any state or federal court or an agreed settlement in a civil action against the licensee or certificate holder concerning professional accounting services or professional accounting work or a finding of a breach of fiduciary duty, fraud or misappropriation; or
 5. The loss of a professional license from another state or federal regulatory agency such as an insurance license or a securities license, resulting from an unappealable adverse finding.
- b) The report required by subsection (a) of this section shall be signed by the licensee or certificate holder and shall set forth the facts which constitute the reportable event. If the reportable event involves the action of an administrative agency or court, then the report shall set forth the title of the matter, court or agency name, docket number, and dates of occurrence of the reportable event.
 - c) Nothing in this section imposes a duty upon any licensee or certificate holder to report to the board the occurrence of any of the events set forth in subsection (a) of this section either by or against any other licensee or certificate holder.
 - d) As used in this section, a conviction includes the initial plea, verdict, or finding of guilt, plea of no contest, or pronouncement of sentence by a trial court even though that conviction may not be final or sentence may not be actually imposed until all appeals are exhausted.
 - e) Interpretive Comment: A crime of moral turpitude is defined in this chapter as a crime involving grave infringement of the moral sentiment of the community and further defined in §501.90(18) and §519.7 of this title (relating to Discreditable Acts and Misdemeanors that Subject a Certificate or Registration Holder to Discipline by the Board).

Case Study 17

While vacationing in Ft. Lauderdale after a particularly long and arduous tax season, Tom Reynolds, a Texas CPA, partied a little too heartily and got himself arrested and prosecuted for public intoxication.

Question 1: Since Tom's lawbreaking occurred outside of Texas and did not involve his tax practice, is Tom in violation of any of the TSBPA Rules of Professional Conduct? If so, which rule(s)?

Answer: Discreditable Acts (Sec 501.90): A person shall not commit any act that reflects adversely on that person's fitness to engage in the practice of public accountancy. A discreditable act includes final conviction of any crime or imposition of deferred adjudication or community supervision in connection with a criminal prosecution for a crime of moral turpitude, a criminal prosecution involving alcohol abuse or controlled substances. NOTE: Tom Reynolds is not ultimately in violation of this rule unless/until he is convicted of the crime or has deferred adjudication or community supervision imposed.

Question 2: If Tom is ultimately convicted, does he have any further obligation(s) as far as the TSBPA is concerned?

Answer: Yes. In accordance with Reportable Events (Sec 501.91), a licensee shall report in writing to the board within 30 days of the date the licensee has knowledge the conviction or imposition of deferred adjudication of the licensee of a crime of moral turpitude, or any crime which involves alcohol abuse or controlled substances.

Rule 501.92 Frivolous Complaints

A person who, in writing to the board, accuses another person of violating the rules of the board shall assist the board in any investigation and/or prosecution resulting from the written accusation. Failure to do so, such as not appearing to testify at a hearing or to produce requested documents necessary to the investigation or prosecution, without good cause, is a violation of this rule. A person who makes a complaint against another person that is groundless and brought in bad faith, for the purpose of harassment, or for any other improper purpose shall be in violation of this rule.

Case Study 18

Eli Bennett, a CPA in Waco, Texas, was a partner with Chris Williams. Unfortunately, they had a falling out and dissolved their partnership. On learning that most of the clients wanted to continue with Chris, Eli decided to cause a little disruption to Chris's business by reporting to the Texas State Board that Chris made frequent and questionable errors in tax positions. He submitted an older tax return as evidence. On a quick examination, the TSBPA decided that although aggressive, there was a reasonable basis in the tax return. After speaking with Chris, the Board also decided that Eli had submitted a frivolous complaint.

Rule 501.93 Responses

If the Board contacts a CPA and expects a response, the CPA must respond in writing within 30 days (or less if the Board has stated such in the communication.) The CPA must copies of documentation and/or work papers. Failure to respond could indicate lack of fitness to serve as a professional accountant leading to license revocation.

a) A person shall substantively respond in writing, within 30 days, to any communication from the board requesting a response. The board may specify a shorter time for response in the communication when circumstances so require.

The time to respond shall commence on the date the communication was mailed, delivered to a courier or delivery service, faxed or e-mailed to the last address, facsimile number, or e-mail address furnished to the board by the applicant or person.

b) A person shall provide copies of documentation and/or work papers, within 30 days, in response to the board's request at no expense to the board. The board may specify a shorter time for response in the communication when circumstances so require. The time to respond shall commence on the date the request was mailed, delivered to a courier or delivery service, faxed or e-mailed to the last address, facsimile number or e-mail address furnished to the board by a person. A person may comply with this subsection by providing the board with original records for the board to duplicate. In such a circumstance, upon request the board will provide an affidavit from the custodian of records documenting custody and control of the records.

- c) Failure to timely respond substantively to written communications, or failure to furnish requested documentation and/or work papers, constitutes conduct indicating lack of fitness to serve the public as a professional accountant.
- d) Each applicant and each person required to be registered with the board under the Act shall notify the board, either in writing or through the board's website, of any and all changes in either such person's mailing address or telephone number and the effective date thereof within 30 days before or after such effective date.

Rule 501.94 Mandatory Continuing Professional Education

The State Board is very strict about the requirement that CPAs complete their annual CPE. The requirements are that each licensed CPA will complete 120 hours of continuing professional education over a three consecutive year period, with a minimum of 20 hours in each one-year period. In addition, they must take a four hour ethics course that has been approved by the Board every two years, and report the completion of the course on the annual license renewal notice at least every second year.

The Board takes these requirements very seriously and any licensee, and once an individual's license has been suspended for three consecutive years by the Board for failing to complete the 120 hours of CPE required, the individual's certificate may be revoked and the CPA may not be reinstated for at least 12 months from the date of the revocation.

Case Study 19

In 2010, John Jenkins, a Texas CPA with a small public practice, moved his home office from one residence to another in the same city. When his license renewal came due four months later, John communicated his change of address on the license renewal form. Fortunately for John, he needed only 16 hours of CPE to total the minimum of 120 he needed for the last three years, and he was able to take an inexpensive 16 hour online course at the last minute on a non-technical subject unrelated to his accounting practice. The 16 total CPE hours that he reported for the current period increased his total number of non-technical CPE hours for the three year reporting period to 75.

Question: Has John complied with the TSBPA Rules of Professional Conduct? If not, which rules has he violated?

Answer: No, John is not in compliance. He has violated the following rules:

- **Responses (Sec 501.93):** Each applicant and each person required to be registered with the board under the Act shall notify the board, either in writing or through the board's website, of any and all changes in either such person's mailing address or telephone number and the effective date thereof **within 30 days before or after such effective date.**
- **Mandatory CPE (Sec 501.94):** A licensee may not claim *more than fifty percent of the total CPE credit hours required from the non-technical area* in a three year reporting period.
- **Mandatory CPE (Sec 501.94):** A minimum of 120 CPE hours is required every three years, *subject to a minimum of 20 hours per year.*
- **Mandatory CPE (Sec 501.94):** Non-technical courses such as, but not limited to, communications, ethics, behavioral science, practice management and advanced courses in foreign languages relating to accounting, **should be of benefit to a licensee or a licensee's employer(s).**

FYI

When the reported hours are incomplete, the Board sends a "needs letter" to noncompliant license holders advising them of the CPE hours that remain to be completed and reported. Note: The Board is authorized to suspend for up to five the license of any certified public accountant who has violated a rule of professional conduct. As an example of how seriously the State Board takes the CPE requirements, the following information was reported in the July 2013 board minutes.

In the months prior to February 2013, the Board sent letters to 151 license holders advising them that their licenses had not been issued because their CPE requirements had not been met. Then on February 4, 2013, the Board sent hearing notices to each of those license holders who had failed to respond to Staffs prior letters, informing them that a public hearing had been scheduled to determine whether their licenses should be suspended for failing to report the required CPE or for failing to report a sufficient number of continuing education hours for the reporting period. Of these 55 came into compliance by completing the necessary CPE, but 96 individuals did not. The Board then recommended that their licenses be suspended without prejudice for a period of three years or until the license holders come into compliance with the continuing education requirements, and that a \$100 penalty be imposed for each year of non-compliance with the continuing professional education requirements.

The point is clear: Complete your CPE requirements, making sure to take a minimum of 20 per year and the approved ethics course every 2 years. If you do hear from the Board that you haven't met the requirements, respond promptly (within 30 days) and provide any supporting evidence of completion.

Chapter 3 Review Questions

1. Which of the following could a CPA perform for a contingent fee?
 - A. A financial statement review
 - B. A financial statement audit
 - C. If the CPA is representing the client during a review of the client's federal income tax return prospective financial statements at the IRS
 - D. Preparing an original tax return

2. Under which of the following situations should a CPA NOT disclose confidential client information?
 - A. Peer review
 - B. Requests from the State Board
 - C. Pursuant to a court order
 - D. When soliciting new clients

3. According to Rule 501.82, advertising or other forms of solicitation that are false, fraudulent, misleading, or deceptive are NOT permitted, and Texas CPAs shall NOT seek to obtain clients in such a manner. Such activities include all the following EXCEPT:
 - A. Indicating the CPA's professional attainments but not education.
 - B. Implying the ability to influence a court.
 - C. Claiming to be able to save the taxpayer 20% of a determined tax liability.
 - D. Claiming secret knowledge of the IRS which leads to great results.

4. When is the appearance of independence of a Texas CPA most likely to be impaired?
 - A. If the CPA provides appraisal, valuation, or actuarial services for an attest client.
 - B. If the CPA joins a trade association, which is an attest client, and serves in a nonmanagement capacity.
 - C. If the CPA accepts a token gift from an attest client.
 - D. If the CPA serves as an executor and trustee of the estate of an individual who owned the majority of the stock of a closely held client corporation.

5. A Texas CPA's retention of client records as a means of enforcing payment of an overdue fee is an action that is:
 - A. Not addressed by the Texas State Board Rules of Professional Conduct.
 - B. Acceptable if the audit fee is overdue by 90 days or more.
 - C. Prohibited under the Texas State Board Rules of Professional Conduct.
 - D. A violation of GAAS.

6. Rule 501-90 of the Texas State Board rules covers discreditable acts. All of the following are considered discreditable acts EXCEPT:

- A. Conviction of a felony
- B. Exceeding the speed limit and receiving a ticket
- C. Breach of fiduciary responsibility
- D. Use of a controlled substances

Review Question Answers

Chapter 1 Review Questions Feedback

1. All of the following are a major focus of ethics EXCEPT:

- A. Integrity
- B. The compromising of integrity, objectivity and independence of decision making.
- C. Professional competence and due care
- D. Freedom from conflicts of interest

A. Incorrect. A key focus of ethics is the concept of integrity (or honesty). Integrity in broad terms will imply that no business-persons in the course of their business functions should be party to the falsification of any facts or information or make any statement which knowingly is misleading, false or deceptive in a material particular.

B. Correct. The preferred position of many is that one should always avoid concurrent involvement in any business, occupation or activity, which might result in the compromising of integrity, objectivity and independence of decision making.

C. Incorrect. Professional competence and due care implies that business professionals should always perform their functions in accordance with law and regulations. In other words, business transactions and professional functions should not be undertaken unless one possesses the required competence and technical skills.

D. Incorrect. This is a more controversial focus of ethics due to the subjective issue of conflict of interests. The business professional should objectively look at any activities which create a conflict of interest, and then work to avoid or eliminate them.

Chapter 2 Review Questions Feedback

1. Which of the following statements best explains why the CPA profession has found it essential to promulgate ethical standards and to establish means for ensuring their observance?

- A. A distinguishing mark of a profession is its acceptance of responsibility to the public.
- B. A requirement for a profession is to establish ethical standards that stress primarily a responsibility to clients and colleagues.
- C. Ethical standards that emphasize excellence in performance over material rewards establish a reputation for competence and character.
- D. Vigorous enforcement of an established code of ethics is the best way to prevent unscrupulous acts.

A. Correct. According to the Principles section of the Code of Professional Conduct, *The Public Interest*, "Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism." According to the accompanying explanation, "A distinguishing mark of a profession is acceptance of its responsibility to the public."

- B. Incorrect. The responsibility of CPAs is to a public that is not limited to clients and colleagues but includes all those who rely on their objectivity and integrity.
- C. Incorrect. Excellence in performance is but one of the effects of accepting responsibility to the public.
- D. Incorrect. Vigorous enforcement is significant but secondary to the creation of an environment in the profession that fosters voluntary adherence to ethical principles.

2. The AICPA Code of Professional Conduct states, in part, that a CPA should maintain integrity and objectivity. What CPA ability does objectivity in the Code refer to?

- A. To maintain an impartial attitude on all matters that come under the CPA's review.
- B. To independently distinguish between accounting practices that are acceptable and those that are not.
- C. To be unyielding in all matters dealing with auditing procedures.
- D. To independently choose between alternate accounting principles and auditing standards.

A. Correct. According to the Principles, *Objectivity*, "Objectivity is a state of mind, a quality that lends itself to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest."

- B. Incorrect. The CPA uses both judgment and GAAP to evaluate whether a client's accounting practices are acceptable.
- C. Incorrect. The CPA is expected to use professional judgment, which may include flexibility, in applying audit procedures.

D. Incorrect. Auditing standards are concerned with the quality of the auditor's performance, whereas adherence to accounting principles by management is a prerequisite for fairly stated financial statements.

3. Which of the following reports may be issued only by an accountant who is independent of a client?

- A. Standard report on an examination of a financial forecast.
- B. Report on consulting services.
- C. Compilation report on historical financial statements.
- D. Compilation report on a financial projection.

A. Correct. Conduct Rule 1.200, *Independence*, states, "A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council." Such standards include Statements on Standards for Attestation Engagements, which apply to, among other things, prospective financial statements (forecasts and projections). Thus, Conduct Rule 101 and the SSAEs require a practitioner to be independent when performing an examination of a financial forecast.

B. Incorrect. Most consulting services are prohibited by the Sarbanes-Oxley (SOX) Act of 2002.

C. Incorrect. Independence is not required of compilation reports on historical financial statements. It is a requirement of prospective financial statements (forecasts and projections).

D. Incorrect. Compilation reports on financial projections do not require independence. A CPA who is not independent may not express an audit opinion or issue a review report, but (s)he may issue a compilation report after disclosing the lack of independence.

4. According to Conduct Rule 1.600, *Advertising and Other Forms of Solicitation*, advertising or other forms of solicitation that are false, misleading, or deceptive are NOT in the public interest, and AICPA members in public practice shall NOT seek to obtain clients in such a manner. Such activities include all the following EXCEPT those that _____

- A. Indicate the CPA's educational and professional attainments.
- B. Imply the ability to influence a court.
- C. Claim to be able to save the taxpayer 20% of a determined tax liability.
- D. Create unjustified expectations of favorable results.

A. Correct. Advertising and solicitation are acceptable as long as they do not involve falsehood or deception.

B. Incorrect. Advertisements suggesting any influence over courts, tribunals, regulatory agencies, or a similar body or official are deceptive and prohibited.

C. Incorrect. A correct amount of tax liability exists and any claim to save a taxpayer part of that amount are prohibited under Rule 502 because they are misleading and against public interests.

D. Incorrect. It is misleading to create false and unjustified expectations of favorable results.

5. When is AICPA Conduct Rule 1.700 violated?

- A. When a member in public practice provides client profit and loss percentages to a trade association without the client's consent.
- B. When a member in public practice uses outside computer services to process tax returns.
- C. When a member in public practice performs consulting services for similar clients.
- D. When a member in public practice advises potential consulting services clients about previous problems on similar engagements.

A. Correct. AICPA Conduct Rule 1.700, *Confidential Client Information*, states that, prior to disclosing confidential client profit and loss percentages to a trade association, the CPA must have specific client consent.

B. Incorrect. According to the Ethics Rules, using outside computer services to process tax returns is permissible as long as client confidentiality is maintained.

C. Incorrect. Most CPAs perform consulting services for clients in the same or related industries, and as long as the member doesn't share confidential information, it is permissible to have clients in similar business activities.

D. Incorrect. According to AICPA Conduct Rule 1.700, *Confidential Client Information*, CPAs must make full disclosure about any reservations concerning the usefulness of potential consulting services, especially those based on past experience with similar engagements. However, the use of any specific client information must remain confidential or be waived by the client.

Chapter 3 Review Questions Feedback

1. Which of the following could a CPA perform for a contingent fee?

- A. A financial statement review
- B. A financial statement audit
- C. If the CPA is representing the client during a review of the client's federal income tax return prospective financial statements at the IRS
- D. Preparing an original tax return

A. Incorrect. A CPA cannot accept a contingent during a financial statement review.

B. Incorrect. A contingent fee could affect a CPA's appearance of independence.

C. Correct. A CPA can represent the client in this instance because a taxing authority will be performing a substantive review.

D. Incorrect. CPAs should not prepare original or amended federal, state, local or other jurisdiction tax returns for a contingent fee for any client during a period requiring independence.

2. Under which of the following situations should a CPA NOT disclose confidential client information?

- A. Peer review
- B. Requests from the State Board
- C. Pursuant to a court order
- D. When soliciting new clients

A. Incorrect. CPAs may provide necessary documentation, including confidential client information, during peer reviews.

B. Incorrect. A CPA should provide confidential information as requested during an investigation or proceeding conducted by the Board.

C. Incorrect. Confidential client information must be provided under a court order signed by a judge.

D. Correct. A CPA must not disclose any confidential client information without their permission when communicated with any other existing or prospective clients.

3. According to Rule 501.82, advertising or other forms of solicitation that are false, fraudulent, misleading, or deceptive are NOT permitted, and Texas CPAs shall NOT seek to obtain clients in such a manner. Such activities include all the following EXCEPT:

- A. Indicating the CPA's professional attainments but not education.
- B. Implying the ability to influence a court.
- C. Claiming to be able to save the taxpayer 20% of a determined tax liability.
- D. Claiming secret knowledge of the IRS which leads to great results.

A. Correct. Advertising and solicitation are acceptable as long as they do not involve falsehood or deception. The advertisement does not to include the educational information.

B. Incorrect. Advertisements suggesting any influence over courts, tribunals, regulatory agencies, or a similar body or official are deceptive and prohibited.

C. Incorrect. A correct amount of tax liability exists and any claim to save a taxpayer a certain percentage of that amount is prohibited under Rule 501.82 because it are deceptive.

D. Incorrect. It is misleading to create false and unjustified expectations of favorable results, especially if it implies the ability to improperly influence any court, tribunal, regulatory agency or similar body or official due to some special relations.

4. When is the appearance of independence of a Texas CPA most likely to be impaired?

A. If the CPA provides appraisal, valuation, or actuarial services for an attest client.

B. If the CPA joins a trade association, which is an attest client, and serves in a nonmanagement capacity.

C. If the CPA accepts a token gift from an attest client.

D. If the CPA serves as an executor and trustee of the estate of an individual who owned the majority of the stock of a closely held client corporation.

A. Incorrect. Independence is not necessarily impaired if the CPA does not perform management functions or make management decisions, if all significant matters of judgment are determined or approved by the client, and the client is in a position to make an informed judgment.

B. Incorrect. Independence is not impaired by simply joining an association or club. However, the CPA should not hold any management positions with the association could create a conflict of interest.

C. Incorrect. A token gift will not impair independence. However, a CPA who accepts more than a token gift, even with the knowledge of the member's firm, will appear to lack independence.

D. Correct. According to an Interpretation of AICPA Conduct Rule 101, independence is impaired if, during the period of the professional engagement, "a covered member was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the client." An Ethics Ruling states that mere designation as trustee or executor does not impair independence in the foregoing circumstances but that actual service does.

5. A Texas CPA's retention of client records as a means of enforcing payment of an overdue fee is an action that is:

A. Not addressed by the Texas State Board Rules of Professional Conduct.

B. Acceptable if the audit fee is overdue by 90 days or more.

C. Prohibited under the Texas State Board Rules of Professional Conduct.

D. A violation of GAAS.

A. Incorrect. This is addressed in the Rules. CPAs should return the records regardless of whether they receive payment.

B. Incorrect. The length of overdue payment has no bearing on the requirement that the CPA return the records.

C. Correct. Rule 501.76 clearly states a person shall return original client records to a client or former client within a reasonable time not to exceed 10 business days after the client or former client has made a request for those records.

D. Incorrect. This is not a violation of GAAS, generally accepted auditing standards; it is a violation of the Code of Professional Standards.

6. Rule 501-90 of the Texas State Board rules covers discreditable acts. All of the following are considered discreditable acts EXCEPT:

A. Conviction of a felony

B. Exceeding the speed limit and receiving a ticket

C. Breach of fiduciary responsibility

D. Use of a controlled substances

A. Incorrect. A discreditable act includes final conviction of a felony or imposition of deferred adjudication or community supervision in connection with a criminal prosecution of a felony under the laws of any state or the United States

B. Correct. A speeding ticket is not sufficient to make the discreditable acts list.

C. Incorrect. A discreditable act includes fiscal dishonesty or breach of fiduciary responsibility of any type.

D. Incorrect. The board has found in §519.7, Misdemeanors that Subject a Licensee or Certificate Holder to Discipline by the Board, that any crime involving alcohol abuse or controlled substances directly relates to the practice of public accountancy, and is a discreditable act.

Glossary

Acceptable level

A level where a reasonable and informed third party would likely conclude, weighing all specific facts and circumstances, that compliance with the rules is not compromised.

Attest engagement

An engagement in which a practitioner will issue or does issue a written communication that expresses a conclusion about the reliability of a written assertion of another party. This engagement requires independence.

Attest engagement team

Participants in the engagement, including partners who perform concurring or second reviews and all employees and contractors retained by the firm, but excluding specialists.

Audit committee

Selected members of a client's board of directors whose responsibilities include helping auditors to remain independent of management.

Client

Any person or entity, other than the member's employee, that engages a member or a member's firm to perform professional services.

Close relatives

Parents, siblings, or nondependent children.

Confidential client information

Client information that may not be disclosed without the specific consent of the client except under authoritative professional or legal investigation

Corporate governance

The system of checks and balances designed to ensure that corporate managers are just as vigilant on behalf of long-term shareholder value as they would be if it was their own money at risk. It is also the process whereby shareholders—the actual owners of any publicly traded firm—assert their ownership rights, through an elected board of directors and the CEO and other officers and managers they appoint and oversee.

Covered member

- An individual on the attest engagement team or who is able to influence the engagement.
- A partner or manager who provides at least 10 hours of nonattest services to a client.
- A partner in the office where the lead engagement partner primarily practices in relation to the engagement, (4) the firm (including its benefit plans), and (5) an entity that can be controlled by the foregoing parties.

Deontology (Kantian ethics)

The concept of duty and the rightness of acts. It emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences.

Direct financial interest

The ownership of stock or other equity shares by members or their immediate family.

Ethical dilemma

A situation in which a decision must be made about the appropriate behavior.

Ethics

Standards of professional conduct and business practices adhered to by professionals in order to enhance their profession and maximize idealism, justice and fairness when dealing with the public, clients and other members of their profession.

Financial institution

An entity that normally makes loans to the public.

Firm

A form of organization permitted by law or regulation that is consistent with the resolutions of the AICPA's Council and practices public accounting. The term "firm" includes the individual partners thereof except for the purposes of Rule 101, *Independence*.

Immediate family

A covered member's spouse, equivalent of a spouse, or dependents.

Independence of mind

The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

Independence in appearance

The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.

Independence in fact

The auditor's ability to take an unbiased viewpoint in the performance of professional services.

Independence Standards Board (ISB)

An autonomous private-sector body established under an agreement between the SEC and the AICPA to provide a conceptual framework for independence issues related to audits of public companies. The ISB dissolved around 2001 (ISB existed 1997-2001).

Indirect financial interest

A close, but not direct, ownership relationship between the auditor and the client; an example is the ownership of stock by a member's grandparent.

Individual in a position to influence the attest engagement

One who (1) evaluates the attest engagement partner or recommends his/her compensation; (2) directly supervises or manages that partner, including all levels above such supervisor or manager; (3) consults with the engagement team about technical or industry-related issues; or (4) participates in or oversees quality control for the engagement, including all senior levels.

Institute

The American Institute of Certified Public Accountants (AICPA).

Internal Control Report

A report on the company's internal control over financial reporting required under Section 404 of the Sarbanes-Oxley Act. For example, the report must include a statement of management's responsibility for internal control.

Interpretations

The means used to explain the application of the spirit of a Principle or Rule to specific situations in which the Principle or Rule may not be sufficiently clear or explicit.

Joint closely held investment

An investment in any entity or property by the member and (1) the client, (2) the client's officers or directors, or (3) an owner who can exercise significant influence if the investment permits such parties to control the entity or property.

Key position

One in which an individual is primarily responsible for significant accounting functions supporting material financial statement components or for the preparation of the statements. A key position is also one able to influence financial statement content, for example, director, CEO, CFO, general counsel, chief accountant, director of internal audit, or treasurer.

Laws

Bodies of rules governing members of a community, state, organization, professional, etc. and enforced by authority or compelling legislation.

Member

A member, associate member, or international associate of the AICPA.

Moral

An accepted rule or standard of human behavior.

Normal lending procedures, terms, and requirements

Those reasonably comparable with those for similar loans to others from the financial institution in the period when a commitment was made for a loan to a covered member.

Objectivity

A state of mind, a quality that lends itself to a member's services. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

Period of the professional engagement

The period that starts at the earlier of when the member signs an initial engagement letter to perform attest services or begins to perform. It continues for the entire professional relationship; it does not end with the issuance of a report and start again with the next year's engagement. This period ends with the later of notification by the member or client or by issuance of a report.

Principles

Broad guidelines for behavior and are not intended to be specific. Principles cover the concepts of responsibilities to the public, integrity, objectivity and independence, professional due care, as well as to whom the principles apply.

Privileged information

Client information that the professional cannot be legally required to provide; information that an accountant obtains from a client is confidential but not privileged.

Public company accounting oversight board (PCAOB)

(www.pcaobus.com) established in 2002 as a result of the Sarbanes-Oxley Act, a private sector, non-profit corporation set up to oversee the audits of public companies and ensure that accountancy firms should no longer derive non-audit revenue streams, such as consultancy, from their audit clients.

Rules

Enforceable guidelines that govern all services performed by the CPA in the practice of public accounting.

Safeguards

Actions or other measures to eliminate threats or reduce them to acceptable levels.

Sarbanes-Oxley Act (SOX)

Wide-ranging U.S. corporate reform legislation, coauthored by the Democrat in charge of the Senate Banking Committee, Paul Sarbanes, and Republican Congressman Michael Oxley. The Act, which became law in July 2002, lays down stringent procedures regarding the accuracy and reliability of corporate disclosures, places restrictions on auditors providing non-audit services and obliges top executives to verify their accounts personally. Section 409 is especially tough and requires that companies must disclose information on material changes in the financial condition or operations of the issuer on a rapid and current basis.

Special purpose entities (SPEs)

A type of corporate entity or limited partnership created for a specific transaction or business, especially one unrelated to a company's main business. Their losses and risks generally aren't recorded on a company's balance sheet.

Threat

The risk that relationships or circumstances could compromise a member's compliance with the rules.

Utilitarianism (teleological ethics)

The promotion that the best long-term interest of everyone concerned should be the moral standard. One should take those actions that lead to the greatest balance of good versus bad consequences.

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Final Examination

Please select the single best answer and transfer it to the preceding score sheet or take the online exam. The questions are the same.

1. Ethics is NOT focused on _____.
 - A. Integrity
 - B. Consistency and uniformity
 - C. Honesty
 - D. Profession competence and due care

2. What is the main reason for ethical guidelines?
 - A. To provide an exact solution to every problem
 - B. To set the statutes, rules, and regulations
 - C. To aid in the decision-making process
 - D. To set an ethical model

3. When CPAs are able to take an unbiased viewpoint in the performance of professional services, it is referred to as independence _____.
 - A. In fact
 - B. In appearance
 - C. In conduct
 - D. In total

4. Which AICPA Conduct Rule applies only to members in the practice of public accounting?
 - A. Compliance with Standards
 - B. General Standards
 - C. Accounting Principles
 - D. Contingent fees

5. Which of the following is NOT one of the AICPA's main principles for ethical conduct?
 - A. Freedom
 - B. Due Care
 - C. Public Interest
 - D. Responsibility

6. Which of the following statements best explains how the accounting profession defines responsibility?
- A. Acting to benefit the public interest, honor the public trust and demonstrate commitment to professionalism
 - B. A reputation for competence and character
 - C. Exercising sensitive professionalism and moral judgments in all their activities
 - D. A requirement for a professional to strive for improved competence and quality service
7. Which of the following most completely describes how independence has been defined by the accounting profession?
- A. Performing an audit from the viewpoint of the public.
 - B. Avoiding the appearance of significant interests in the affairs of an audit client.
 - C. Possessing the ability to act with integrity, objectivity, and professional skepticism.
 - D. Accepting responsibility to act professionally and in accordance with a professional code of ethics.
8. When a CPA is associated with financial statements that do NOT comply with promulgated GAAP because the statements would be misleading without the departure, the CPA is NOT required to disclose which of the following?
- A. The departure
 - B. The approximate effects of the departure in comparison to the application of GAAP
 - C. The reason the departure does not have a material effect on the statements
 - D. The reasons compliance would have been misleading
9. The CPA must NOT subordinate his or her professional judgment to that of others _____.
- A. In every engagement
 - B. In every audit engagement
 - C. In every engagement except tax services
 - D. In every engagement except management advisory services
10. Mark is the executive partner of Mark & Co., CPAs. One of its smaller clients is a large nonprofit charitable organization. The organization has asked Mark to be on its board of directors, which consists of a large number of the community's leaders. Membership on the board is honorary. When would Mark & Co. would be considered to be independent?
- A. Under no circumstances
 - B. As long as Mark's directorship was disclosed in the organization's financial statements
 - C. As long as Mark was not directly in charge of the audit
 - D. As long as Mark does not perform or give advice on management functions of the organization

11. According to the profession's ethical standards, an auditor would be considered independent in which of the following instances?
- A. The auditor's checking account, which is fully insured by a federal agency, is held at a client financial institution.
 - B. The auditor is also an attorney who advises the client as its general counsel.
 - C. A member donates service as treasurer of a charitable organization that is a client during the period covered by the financial statements.
 - D. The client owes the auditor fees for two consecutive annual audits.
12. According to the Board Rules, which of the following acts is generally prohibited?
- A. Buying a product from a third-party and reselling it to a tax client
 - B. Writing a financial management newsletter promoted and sold by a publishing company
 - C. Accepting a commission for recommending a product to an audit client
 - D. Accepting engagements obtained through the efforts of third parties
13. In which of the following situations may a CPA in public practice receive a contingent fee from an audit client?
- A. For a review of a client's previous financial statements
 - B. For a state or local tax return
 - C. If the client fees total less than \$5,000
 - D. During representation before the IRS
14. Which of the following is NOT an element of competence as defined by the Board Rules for a Texas CPA?
- A. Technical qualifications
 - B. Ability to supervise and evaluate all work performed
 - C. Professional care in performance
 - D. Ability to complete the work without relying on additional research or consultation
15. A Texas CPA is permitted to disclose confidential client information without the consent of the client to which of the following: I.) Another CPA firm if the information concerns suspected tax return irregularities; II.) in the course of peer reviews, III.) investigations or proceedings conducted by the Board.
- A. I only
 - B. II only
 - C. I and II
 - D. II and III
16. Which of the following actions by a CPA most likely violates the profession's ethical standards?
- A. Arranging with a financial institution to collect notes issued by a client in payment of fees due
 - B. Compiling the financial statements of a client that employed the CPA's spouse as a bookkeeper
 - C. Retaining client records after the client has demanded their return
 - D. Purchasing a segment of an insurance company's business that performs actuarial services for a client's employee benefit plans

17. Tony Sessa, CPA, knew that he had to be careful NOT to create any false, fraudulent, deceptive or misleading advertisements. Following these guidelines, he created a number of Facebook ads to target non-clients. How long must Tony keep a copy of the advertisement?

- A. Tony does not need to keep a copy because it was not a printed advertisement.
- B. Tony must keep a copy for 12 months after the start of the first advertisement.
- C. Tony must file a copy of the advertisement with the Board within 3 months of first public placement.
- D. Tony must keep a copy of the advertisement for at least 3 years after it was last seen.

18. Which of the following is a valid name for a Texas CPA firm that is sole proprietorship with a bookkeeper on the staff as well?

- A. Tim Jones, CPA
- B. Susan Williams and Associates, CPA
- C. Miguel Romero, PLLC
- D. The Tax Guy

19. Which of the following is NOT a discreditable act?

- A. Fraud or deceit in obtaining a certificate as a CPA or in obtaining registration under the Act or in obtaining a license to practice public accounting
- B. Dishonesty, fraud or gross negligence in the practice of public accountancy
- C. Failure to comply with a final order of any state or federal court
- D. Failure to respond to a client's inquiry within 7 days

20. Which of the following statements about CPE requirements for a Texas CPA is TRUE?

- A. A Texas CPA must complete take 80 hours of CPE every 2 years.
- B. A Texas CPA must complete an ethics course approved by the Board every 3 years.
- C. A Texas CPA must complete a minimum of 30 CPE hours per year.
- D. A Texas CPA must complete 120 hours every three years